

**PROFIT/LOSS SHARING AND RISK IN THE ISLAMIC  
BANKING SYSTEM  
WITH A  
SPECIAL REFERENCE TO MALAYSIA**

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## **In the Name of Allah, the Merciful, the Compassionate**

I, the undersigned, hereby declare that this thesis has been written by myself and any references made to the sources have been duly acknowledged. I also declare that this thesis has not been submitted for any other degree or professional qualification except as specified.

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## Abstract

Despite its indisputable recent expansion, Islamic banking is still poorly understood in many parts of the Muslim world and it is a puzzle to much of the West. Its practice varies from one country to another, for it is subject to different interpretations of the Shari'a by the local *fuqaha*. Many scholars believe that Islamic banking should place equal emphasis on ethics and profitability to enhance equality and fairness in society as a whole. Although the concept of profit/loss sharing is generally considered the most appropriate form of Islamic contract, its application to the Islamic banking system has provoked some criticism. Islamic banks need to make a profit if they are to compete with conventional banks, which focus exclusively on profit maximization. The profit generated by Islamic banks would allow them to offer higher remuneration to their shareholders and depositors and to invest in product innovation and technology.

This study explores various aspects of Islamic banking, especially its basis of the Shari'a. The discussion includes a look at the history of banking, the development of financial intermediaries and the importance of Islamic banks in this role to cater for the needs of Muslims, and the basic principles of Islamic economics. To understand why Islamic banks do not operate fully according to the principles of profit/loss sharing, particularly in Malaysia, it is necessary to analyse the reasons for this situation.

The main challenge to Islamic banking in modern society is risk. Unlike conventional banks, Islamic banks are constrained by the Shari'a's prohibition of *riba* on investments and financing, so risk management is top priority. This thesis examines

risk in detail: how its concept is viewed by scholars and financial organizations around the world and its management in practice with special reference to the financial systems in Malaysia, using Bank Islam (M) Berhad, its first Islamic bank, as a case study. Using historical and modern evidence, the thesis analyses the possible means of managing risk in Islamic banking so that the Islamic banks comply with the Shari‘a, yet be fully competitive with their conventional counterparts.

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## Abbreviations

**AIBIM:** Association of Islamic Banking Institutions Malaysia

**BAFIA:** Banking and Financial Institutions Act

**BIMB:** Bank Islam Malaysia Berhad

**BNM:** Bank Negara Malaysia or Central Bank of Malaysia

**IAIB:** International Association of Islamic Banks

**IBA 1983:** Islamic Banking Act 1983

**IBFIM:** Islamic Banking and Finance Institute Malaysia Sdn Bhd

**IDB:** Islamic Development Bank

**IFI:** Islamic Financial Institution

**IFSB:** Islamic Financial Services Board

**IIFM:** International Islamic Financial Market

**INCEIF:** International Centre for Education in Islamic Finance

**LMC:** Liquidity Management Centre

**NSAC:** National Shari'a Advisory Council

**PBUH:** peace be upon him

**PLS:** profit and loss sharing

**RENTAS:** Real Time Electronic Transfer of Funds and Securities or *Sistem  
Penjelasan Kasar Masa Nyata*

**SPEEDS:** Electronic Transfer System for Funds and Securities or *Sistem  
Pemindahan Elektronik untuk Dana dan Sekuriti*

## Introduction

In 1970, Islamic banking was almost unknown. By the early years of the twenty-first century, however, Islamic banking has become a reality that cannot be ignored, for it is growing at a steady pace. The value of Shari'a-compliant accounts worldwide is estimated to be between US\$200 billion and US\$500 billion and it is growing at an average annual rate of 10–15 per cent.<sup>1</sup> It is predicted that Islamic banks will control around 40–50 per cent of Muslims' savings by 2009/10, for the population of Muslims in the world in 2006 has been calculated to be more than 1.2 billion.<sup>2</sup> It should be noted, however, that banking is the most developed part of the Islamic financial system, which also covers capital markets and all types of financial intermediation.

It is difficult to date precisely the establishment of the first modern Islamic bank. Most of the literature states that the first modern Islamic savings bank was opened in the Egyptian town of Mit Ghamr during the 1960s. That experiment did not last very long, and it was not until 1975, when the Nassir Social Bank was established as an interest-free commercial bank in Egypt, that Islamic banking began to take hold in the Muslim world. From that beginning, Islamic banking increased by 2006 to more than 300 Islamic financial institutions in more than 75 countries. The entire banking system in Iran, Pakistan and Sudan has been converted to Islamic

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<sup>1</sup> Statement by the Deputy Prime Minister of Malaysia, Datuk Seri Najib Razak, when officiating at the opening of the Islamic Financial Forum in Kuala Lumpur. See, Kamarul Yunus, "Malaysia Faces Increasing Competition in Islamic Banking", *Business Times* (2005). Cited 30 November 2005 from <http://www.btimes.com.my>.

<sup>2</sup> Tarek S. Zaher and M.Kabir Hassan, "A Comparative Literature Survey of Islamic Finance and Banking", *Financial Markets, Institutions and Instruments*, vol.10, no.4 (2001), p.170.

banking.<sup>3</sup> In addition, Malaysia, Indonesia and Jordan are among the countries that have chosen to operate Islamic banking alongside the conventional system. This is achieved by the opening of “Islamic windows”<sup>4</sup> in conventional institutions or the establishment of separate banks or branches and subsidiaries specializing in Islamic financial products.

It should be borne in mind that although the emergence of Islamic banking was in response to the market needs of Muslims, these banks are not religious institutions, for they provide banking services for non-Muslim customers as well. An important development in Islamic banking in the early years of the twenty-first century has been the entry of some conventional banks into the Islamic market. Outside the Muslim world, Islamic banking facilities have been offered by many countries, such as Denmark and Great Britain, as well as by some of the international banking giants, like the Hong Kong and Shanghai Banking Corporation, Citibank, and Chase Manhattan. In the capital market during this period, Dow Jones has created more than 60 Islamic market indexes that follow Shari‘a-compliant stocks in many global markets.<sup>5</sup> Dow Jones rejects companies whose practices are incompatible with Shari‘a principles, for example, if they have material ownership in or revenue from prohibited activities, such as intoxicants, gambling and pig products. Manufacturers of tobacco and armaments, although not strictly forbidden in the Shari‘a, are also excluded from the index.<sup>6</sup>

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<sup>3</sup> Rajesh K. Aggarwal and Tarik Yousef, “Islamic Bank and Investment Financing”, *Journal of Money, Credit and Banking*, vol.32, no.1 (2000), p.93.

<sup>4</sup> Islamic windows are special facilities offered by conventional banks to provide services to Muslims who wish to engage in Islamic banking.

<sup>5</sup> Dow Jones Islamic Fund Website: <http://www.djindexes.com> . Cited on 8 December 2006.

<sup>6</sup> Ibid.

Despite its expansion, Islamic banking is still poorly understood in many parts of the Muslim world and it is a puzzle to much of the West. If Muslims are confused, then in the view of non-Muslims, the Islamic banking system seems too complex, for it is markedly different from conventional banking operations. Indeed, the practice of Islamic banking varies from one country to another, for it is subject to different interpretations of the Shari'a by the local *fugaha*. It is also governed by local laws and financing policy. The Western perspective has been clearly expressed by Divanna:

Finding a single definition of Islamic banking and finance is difficult to come by, due to numerous interpretations. To most Western bankers and some Muslims, the general definition of what constitutes Islamic banking appears ambiguous, differing slightly in each country, becoming less clear as one gets closer to the details of financial instruments and transactions.<sup>7</sup>

According to Warde,

No definition of Islamic finance is entirely satisfactory. To every general criterion – a financial institution owned by Muslims, catering to Muslims, supervised by a Shari'a Board, belonging to the International Association of Islamic Banks (IAIB), etc.<sup>8</sup>

In short, Islamic banking can be classified as a financial system organized on a basic element of Islam, that is, the Shari'a. Specifically, the *fiqh al-mu'amalat* (Islamic commercial law) regulates the relationship among human beings and covers all trade-related and economic activities. None of the four basic elements can be separated from its inter-relationship with the others, for each element represents an essential part of the whole religion of Islam. Therefore, although Islamic banks offer mostly the same functions as the conventional banks, they do this in distinctly differ-

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<sup>7</sup> Joseph A. Divanna, *Understanding Islamic Banking: The Value Proposition that Transcends Cultures* (Cambridge, UK: Leonardo and Francis Press, 2006), p.1.

<sup>8</sup> Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh, UK: Edinburgh University Press, 2000), p.5.

ent ways from their conventional counterparts. Many scholars, such as Chapra, Iqbal, Taqi Usmani, Warde, Lewis and Algoud and Iqbal and Molyneux, believe that Islamic banking should place equal emphasis on the ethical, moral, social and religious aspects of financial dealings to enhance equality and fairness in society as a whole.<sup>9</sup> The prohibition of *riba*, *maysir* (gambling) and *gharar* are to protect the interests of all the parties concerned and thus to promote social harmony. Although the prohibition of interest is the nucleus of the Islamic financial system, describing it simply as “interest free” does not give the whole picture, for it is supported by other principles of Islamic doctrine, such as advocating risk-sharing, individuals’ rights and duties, property rights and the sanctity of the contract.<sup>10</sup> Therefore, another unique feature of Islamic banking is the construction of a system that promotes risk sharing, co-operation, mutual assistance, and the sharing of the profits between the investors and the users of funds.

The ethical and moral aspects are also reflected in the commercial dealings in which the Islamic banks engage, for these organizations cannot support or invest in companies whose activities conflict with the moral principles of Islam. Even though the transactions themselves might be free of *riba*, *maysir* and *gharar*, they can still be deemed unlawful according to the Shari‘a if they are connected with banned items such as alcohol, pig products and gambling as well as immoral activities such as

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<sup>9</sup> See, Muhammad Umer Chapra, *Towards a Just Monetary System* (Leicester, UK: The Islamic Foundation, 1985); Zamir Iqbal, “Islamic Financial Systems”, *Finance and Development* (June 1997), pp.42–45; Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (New Delhi: Idara Isha‘at-e-Diniyat, 1999); Warde, op. cit.; Mervyn K. Lewis and Latifa M. Algaoud, *Islamic Banking* (Cheltenham, UK: Edward Elgar, 2001); Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (Basingstoke, UK: Palgrave Macmillan, 2005). A brief discussion of the theory of Islamic banking can be found in Muhammad Nejatullah Siddiqi, *Banking without Interest* (Leicester, UK: The Islamic Foundation, 1983a).

<sup>10</sup> Iqbal, op. cit., p.42.

pornography and prostitution. Thus, there is an ethical and moral filter in Islam, based on the definition of *halal* (permissible) and *haram* (prohibited).

The unique feature of the Islamic banking system is that its nature and structure promote social responsibility. It is a method of organizing financial transactions based on Shari'a principles, thus connecting the system with a genuine concern for ethically and socially responsible activities. Its aim is to provide socio-economic benefits to the community, rather than being driven by profit maximization.<sup>11</sup> The International Association of Islamic Banks (IAIB) comments as follows on this aspect of Islamic banking:

The Islamic bank takes into prime consideration the social implications that may be brought about by any decision or action taken by the bank. Profitability – despite its importance and priority – is not therefore the sole criterion or the prime element in evaluating the performance of Islamic banks, since they have to match both between the material and the social objectives that would serve the interests of the community as a whole and help achieve their role in the sphere of social mutual guarantee. Social goals are understood to form an inseparable element of the Islamic banking system that cannot be dispensed with or neglected.<sup>12</sup>

Nevertheless, Islamic banks are not charitable organizations, for they must also make a profit if they are to compete with conventional banks, which focus exclusively on profit maximization. The profit generated by Islamic banks would allow them to offer higher remuneration to their shareholders and depositors and to invest in product innovation and technology. Scholars point out that although profit is important to Islamic banks, this should not be their sole or primary goal.<sup>13</sup> It is also suggested that being Islamic organizations, they are expected to achieve only a

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<sup>11</sup> See footnote 9.

<sup>12</sup> Warde, op. cit., p.153.

<sup>13</sup> Ibid., p.154. Warde stated that in Iran, a maximum rate of profit is determined by the Central Bank.



reasonable rate of return.<sup>14</sup> To date, however, there has no clear means of determining a fair price or a reasonable rate. Indeed, Islamic banks have to compete with conventional banks in a world in which the conventional banks do not play by the same rules.

It is accepted by most scholars of Islam that a banking system constructed to promote risk-sharing, co-operation and mutual assistance is reflected in the principle of profit/loss sharing, which, in turn, is the cornerstone of Islamic banking. *Mudaraba* and *musharaka* are both forms of profit/loss sharing.<sup>15</sup> As stated by Warde, the principle of profit/loss sharing

is at once the most “authentic” form of Islamic finance since it replicates transactions that were common in the early days of Islam, the one that is most consistent with the value system and the moral economy of Islam and the most “modern” one. Thus, it is believed that Islamic banks are supposed to offer instruments consistent with the religious beliefs and cultural characteristics of Muslim societies.<sup>16</sup>

Although most scholars consider profit/loss sharing the most valid and most favourable form of Islamic contracts, its application to the Islamic banking system has received some criticism. For example, Naqvi argues that the institution of *mudaraba* is not sacred, since it is not based on the Qur'an and Hadith but was the

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<sup>14</sup> For example, Sudin Haron states: “Like any other business entity, Islamic banks are expected to make a profit from their operations. It is considered unjust of Islamic banks if they are unable to provide sufficient returns to the depositors who have entrusted their money to them. While making a profit from the business is allowed in Islam, at the same time Muslims are prohibited from committing any excess. Applying this message to banking operations means that Islamic banks are prohibited from making excessive profit at the expense of their customers.” Sudin Haron, “The Philosophy of Islamic Banking”, in *Anthology of Islamic Banking*, ed. Asma Siddiqi (London: Institute of Islamic Banking and Insurance, 2000), p.58.

<sup>15</sup> See, for example, Laurance M. Crane and David J. Leatham, “Profit and Loss Sharing in Agriculture: An Application of Islamic Banking”, *Agribusiness*, vol.9, no.4 (1993), p.407; Aggarwal and Yousef, op. cit., p.96.

<sup>16</sup> Warde, op. cit., p.153.

custom of the pre-Islamic Arabs.<sup>17</sup> Borhan points out that the theoretical concept of Islamic banking based on profit/loss sharing was originally developed from the explicit assumption of a general prohibition of interest.<sup>18</sup> Among other objections to the application of these concepts is that a medieval-style contract may not necessarily be suitable for modern economic realities, for it could lead to one party taking advantage of the other as well as creating difficulties in management and regulation.

Ariff asserts that the earlier contributions to the discussion of Islamic banking were little more than a mention in passing.<sup>19</sup> At that time, scholars were concentrating on the wider aspects of Islamic economics or simply making a few comments rather than presenting a carefully considered argument.<sup>20</sup> Then, in 1955, Uzair raised the question of applying *mudaraba* in interest-free banks.<sup>21</sup> However, his argument that a "bank should not make any capital investment with its own deposits" rendered his analysis somewhat impractical."<sup>22</sup> In 1966, al-Arabi suggested the implementa-

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<sup>17</sup> Naqvi states: "It is interesting to note that, according to Ibn Hazm, the institution of *mudaraba* is not based on the Holy Qur'an or on any of the Holy Prophet's tradition. It was only a custom of the pre-Islamic Arabs. *Mudaraba* was practiced in pre-Islamic Arabia. The tribe of Quraish had no other livelihood but trade. The old people, women, children and orphans used to give their capital based on *mudaraba* to the merchants for a certain part of the profit. All the loss in *mudaraba* was borne by the capital owner and not by the merchant, who took the capital for the purpose of trade." Syed Nawab Haider Naqvi, *Ethics and Economics: An Islamic Synthesis* (Leicester, UK: The Islamic Foundation, 1981), p.135.

<sup>18</sup> Joni Tamkin Borhan, "The Doctrine and Application of Partnership in Islamic Commercial Law with Special Reference to Malaysian Experiments in Islamic Banking and Finance". Unpublished PhD thesis (Edinburgh University, 1997), p.190.

<sup>19</sup> Mohamed Ariff, "Islamic Banking", *Asian Pacific Economic Literature*, vol.2, no.2 (September 1988), pp.46-62.

<sup>20</sup> Ibid. Ariff states, for example, that in his discussion of Islam and the theory of interest, Qureshi (1946) regarded banking as a social service, which should be sponsored by the government in the same way as public health and education. However, neither writer mentioned profit sharing. Ariff also reviews Ahmad (1952), stating that Ahmad referred to possible partnership arrangements between businessmen and banks. Yet, there was no definition of the partnership principles, nor was it clear who would bear the loss, if any.

<sup>21</sup> Muhammad Uzair, *An Outline of Interestless Banking* (Karachi, Pakistan: Raihan Publications, 1955).

<sup>22</sup> Ariff, op. cit., p. 51



tion of *mudaraba* principles in the banking system and he also discussed briefly the impact of usury and interest on the community.<sup>23</sup> In 1963, Siddiqi suggested that the Islamic banking model should be based on *mudaraba* and *shirka* (now termed *musharaka*). His work, originally published in Urdu, was not available in English until 1983.<sup>24</sup> However, Siddiqi believed that an Islamic banking system would be successful only in a country where the Shari'a was enforced. Therefore, usury would be prohibited and anyone indulging in activities based on usury would be punished.<sup>25</sup> In the framework suggested by Chapra in 1985, the author emphasizes that there is more to Islamic banking than just the abolition of usury.<sup>26</sup> Chapra's model of Islamic banking demonstrates how it differs from conventional banking, in that its role is oriented more towards social responsibility than the maximization of profit. In addition, Islamic banks should provide equity-oriented financing or profit/loss sharing.<sup>27</sup> In practice, however, contrary to the expectations of the supporters of Islamic banking, most Islamic funds are restricted to short-term and low-risk investments with slim profit margins. Further analysis of lending activities has also found that Islamic banks prefer to lend funds for the short term and secured by collateral. These funds tend to be directed away from agriculture and industry and towards retail or trade financing.<sup>28</sup>

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<sup>23</sup> Mohammad Abdullah al-Arabi, "Contemporary Banking Transactions and Islam's Views Thereon", *Islamic Review* (1966), pp.10–16.

<sup>24</sup> Ariff, op.cit., p.51. See, Muhammad Nejatullah Siddiqi, *Banking without Interest* (Leicester, UK: The Islamic Foundation, 1983a).

<sup>25</sup> Muhammad Nejatullah Siddiqi, *Issues in Islamic Banking* (Leicester, UK: The Islamic Foundation, 1983b).

<sup>26</sup> Ariff, op. cit., p. 52.

<sup>27</sup> Chapra, op. cit., p. 155.

<sup>28</sup> Aggarwal and Yousef, op. cit., p. 94.

Malaysia is a country where 62.8 per cent of the population are Muslim and whose government is committed not only to developing Islamic banking but also to establishing a complete financial system.<sup>29</sup> Indeed, in 2001, to strengthen the industry further, Bank Negara Malaysia (Central Bank of Malaysia) formulated a ten-year strategy as part of its Financial Sector Master Plan to achieve the goal of 20 per cent of banking assets held in Islamic banks by 2010. At the end of 2005, Islamic banking assets constituted only 11.3 per cent of the total banking assets, which indicates that there is a greater potential to be exploited.

Like their fellow Muslims elsewhere, Muslims in Malaysia have for a long time wished to apply the principles of the Shari'a to banking and finance. However, the situation in Malaysia poses a serious challenge to Islamic banks, for they have to compete with the conventional banks, which are already well established and which operate according to a completely different philosophy. It should be noted that it is very difficult for an organization to compete in a different system, where the benchmark of the corporate performance is profit. In addition, the Islamic financial system in Malaysia has been criticized for excessive reliance on the *murabahah* (mark-up) and *bai' bithaman ajil* (deferred payment) since the establishment of the first Islamic bank, Bank Islam (M) Berhad.<sup>30</sup> Thus, the Islamic banks have been accused of being

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<sup>29</sup> Tan Sri Jaafar Hussein, the former governor of Bank Negara Malaysia in November 1991, said: "I have a dream, and my dream is that I will be able to see, in my lifetime, a fully fledged Islamic financial system side by side with the existing conventional system, both equally sophisticated and modern." See, Borhan, op. cit., p.197.

<sup>30</sup> Criticisms include the Islamic banks' over-reliance on these techniques of operation (mark-up and deferred payment), which are suspected of opening the back door to usury. These techniques are also regarded as the counterparts to the practice of usury, as followed by the conventional banks. It has been stated that the mark-up charged by the Islamic banks is about the same as the rate of interest if it is converted into a proportion of the principal.. Therefore, the Islamic banks have been accused of charging interest in a hidden form and operating in a similar way to the conventional banks, though without the "label" of interest.

concerned only with making a profit, while neglecting the welfare aspect of their operations.<sup>31</sup> Some local products are not accepted globally either, owing to objections from Islamic scholars of other countries, who doubt that the system complies fully with the principles of the Shari'a.<sup>32</sup>

## Structure of the Thesis

The issues mentioned above led me to research and understand all that is known about Islamic banking, in particular, its basis and salient features. Since Islamic banking is a sub-division of Islamic economics, it is important to examine the foundation of Islamic economics and some critiques of the system, which have been made by certain scholars. In addition, this study explores the importance of Islamic banks as financial intermediaries to cater for the needs of Muslims. To understand why Islamic banks do not operate fully according to the principles of profit/loss sharing, particularly in Malaysia, it is necessary to study the system itself and its development. Since the question of risk has always been highlighted as the reason for the general lack of profit/loss-sharing modes of financing in the Islamic banking system, it is important to understand this attitude from both the Islamic and conventional perspectives as well as to discover the management of risk in Islamic banking system in Malaysia.

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See, for example, Saiful Azhar Rosly and Mohd Afandi Abu Bakar, "Performance of Islamic and Mainstream Banks in Malaysia", *Journal of Social Economics*, vol.30 no.12 (2003), pp.1249–1265; Sudin Haron and Norafifah Ahmad, "Islamic Financial System in Malaysia: Issues Re-examined". Paper presented at the Muzakarah Pakar: Kearah 20% Pasaran Perbankan Islam 2010: Strategi Sistem Perbankan Islam. Institut Kefahaman Islam (IKIM) and Persatuan Institusi-Institusi Perbankan Islam Malaysia (AIBIM), Kuala Lumpur, 12-13 March, 2002.

<sup>31</sup> It has been asserted that Islamic banks belong to *Tijari* (commercial sector). Therefore, as commercial organizations, Islamic banks need to protect the interests of their depositors and shareholders by maintaining a reasonable rate of return on their investments.

<sup>32</sup> Halim Wahab, "The Debate Continues", *Malaysian Business* (16 May 2004), pp.38–39.

Following this introduction, the thesis is divided into five chapters:

1. Chapter 1 discusses the Shari'a as the comprehensive law of Islam. It also discusses *riba* and its prohibition in Islam. Although *riba* has been covered extensively by many scholars in earlier research, it is important to have a basic knowledge of the subject before proceeding to the rest of the discussion.
2. Chapter 2 examines the requirement for Islamic banks as financial intermediaries to cater for the needs of Muslims and includes historical evidence of deposits and financing practices from the pre-Islamic to the medieval period. The chapter also discusses the basic principles in Islamic economics and how they are viewed by some Islamic scholars. In addition, the critiques of Islamic economics are touched upon.
3. Chapter 3 describes the development of Islamic banking around the world and specifically in Malaysia. This chapter also analyses the implementation of profit/loss-sharing modes of financing in the Islamic banking system in Malaysia with particular reference to Bank Islam (M) Berhad, the first Islamic bank.
4. Chapter 4 analyses the concept of risk from Islamic and conventional perspectives. In this chapter, the comparison of risk and its management in Islamic and conventional banks is also analysed.
5. Chapter 5 discusses the management of risk in the Islamic banking system in Malaysia and in Bank Islam (M) Berhad, as well as the findings of the interviews with Bank Islam (M) Berhad.



In the preparation of this thesis, I have benefited greatly from the following earlier studies:

1. Shahrukh Rafi Khan, *Profit and Loss Sharing: An Experiment in Finance and Banking*. The work was originally a PhD thesis completed at the University of Michigan in the United States in 1987 and was published by the Oxford University Press in 1987. In this work, the author has focused on the Pakistani experiments in Islamic banking. He discusses very briefly the doctrine of partnership as explained by the jurists and also examines the origin of the Islamic banking movement, the institutional and ethical issues underlying it and its adaptation of financial instruments, including profit/loss sharing.
2. Joni Tamkin Borhan, "The Doctrine and Application of Partnership in Islamic Commercial Law with Special Reference to Malaysian Experiments in Islamic Banking and Finance". This work is an unpublished PhD thesis from the University of Edinburgh and the research focuses on Malaysia. Although the author discusses thoroughly the doctrines of partnership in Islamic commercial law, he only briefly analyses the application of profit/loss-sharing modes of financing in the operations of Bank Islam (M) Berhad, Syarikat Takaful and Tabung Haji in Malaysia. No attempt is made to discover the reasons why those institutions have been slow to implement profit/loss-sharing modes of financing.

### **Limitations of the Study**

For the purposes of this research, the fieldwork was conducted in Malaysia. Although it was very helpful, there was still some difficulty in acquiring certain information, especially written documents. Bank Islam Malaysia (M) Berhad refused

to release their internal written documents, for they were strictly confidential. Only the published material was available. This restriction therefore reduced my ability to analyse the written documents used. Nevertheless, the Bank was very helpful in enabling me to conduct interviews as well as giving me a vast amount of oral information on the Islamic banking system, especially concerning risk management in the Bank and in Malaysia. Since my return to Edinburgh, a new management in Bank Islam has been appointed and the organization of the Bank restructured owing to a huge loss in its banking operations. There have also been further developments in the Islamic banking system generally. Information on these events has been limited to newspaper reports and the Bank's *Annual Report* as well as the *Annual Report* from Bank Negara Malaysia (Central Bank of Malaysia), although I have also contacted senior members of the Bank's staff to validate my findings. I hope that my comments will provide useful guidance for future studies.

# CHAPTER ONE

# 1 The Shari'a and the Prohibition of *Riba*

## 1.1 An Overview

Belief in the unity or oneness and indivisibility of God, which is the essence of Islamic teachings, demands that every aspect of human life – political, social, moral, spiritual and economic – is lived in compliance with the Shari'a. As a body of rules and regulations derived from integrated sources, the Shari'a provides fully comprehensive guidance for Muslims in every aspect of their lives in this world. As stated by Schacht:

The sacred law of Islam (Shari'a) is an all-embracing body of religious duties, the totality of Allah's commands that regulate the life of every Muslim in all its aspects; it comprises on an equal footing ordinances regarding worship and ritual, as well as political and (in the narrow sense) legal rules.<sup>1</sup>

As one component of the Shari'a, Islamic economics is designed to ensure the achievement of equality and fairness for the good of society as a whole. The prohibition of *riba* is one of the basic principles of Islamic economics as well as the central tenet of the system. It represents the aim of the Shari'a to effect socio-economic justice in Islam. According to Iqbal:

Islam encourages the earning of profit but forbids the charging of interest, because profits, determined *ex post*, symbolize successful entrepreneurship and creation of additional wealth, whereas interest, determined *ex ante*, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there is a business loss. Social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity.<sup>2</sup>

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<sup>1</sup> Joseph Schacht, *An Introduction to Islamic Law* (Oxford, UK: Oxford University Press, 1984), p.1.

<sup>2</sup> Zamir Iqbal, "Islamic Financial Systems", *Finance and Development* (June 1997), p.43.



On account of the direct relationship between the Shari'a and Islamic economics, this chapter examines the content of the Shari'a and its sources. In addition, there is a brief discussion of the main schools of legal thought (*madhahib*) in Islam, which influence the diversity of Islamic banking. Since *riba* is the focus of the argument, being one of the most important differences between Islamic and Western economics, the chapter analyses its concept and the reasons for its prohibition. It also looks briefly at an assessment of conventional banking practices and the classification of contracts in Islamic economics.

## **1.2 The Shari'a**

### **1.2.1 Definition and Aim of the Shari'a**

Shari'a is an Arabic word meaning a path to be followed, in particular, "the way to a watering place".<sup>3</sup> Muslims believe that this path was revealed by God, Who Alone, as the Sovereign, has the right to ordain a path for the guidance of humankind through His Messenger, Prophet Muhammad (SAW). Islam requires Muslims to strive to implement the path, namely, the Shari'a, for this is the only way in which human beings can be released from servitude to other than God.<sup>4</sup> God is the Law-giver and the whole Umma (Muslim community) is His trustee. Doi outlines the basic principles of the Shari'a as follows:

1. The greater interest of society takes precedence over the interest of the individual.
2. Relieving hardship and promoting benefit are both prime objectives, the former taking precedence over the latter.

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<sup>3</sup> Abdur Rahman I. Doi, *Shari'a: The Islamic Law* (London: Ta Ha Publishers, 1984), p.2.

<sup>4</sup> Ibid., p.10.

3. A greater loss cannot be imposed to offset a smaller loss, nor can a greater benefit be sacrificed for a smaller benefit. On the other hand, a smaller harm can be inflicted to avoid a greater harm or a smaller benefit can be sacrificed for a greater benefit.<sup>5</sup>

The Shari'a is a broader concept than human-made law, for it covers not only faith and practice, but also personal behaviour and legal and social transactions. Therefore, it governs one's whole way of life. The Shari'a is a divinely revealed law and thus has a higher status, for it has not been created by men and women, who, as human beings, are subject to weaknesses and bias. Owing to these characteristics, the Shari'a enjoys a level of stability that does not exist in human-made law. It is a self-contained system, acting as a blueprint for human conduct. Unlike human-made law, its concept of justice is clearly defined and administered in the name of God. Justice must be applied equally, without discriminating between rich and poor within the Umma. As Doi points out:

Some people may be inclined to favour the rich, because they expect something from them. Some people may be inclined to favour the poor, because they are generally helpless. Partiality in either case is wrong. We are asked to be just, without fear or favour. Both the rich and poor are under Allah's protection as far as their legitimate interests are concerned, but they cannot expect to be favoured at the expense of others. Allah can protect the interests of all, far better than man.<sup>6</sup>

The Umma is responsible for administering the Shari'a. Islam is greatly aware of the balance between understanding the rights of individuals within their society and their obligations to their fellow human beings. Justice is the main concern of the Shari'a, which means that everyone must respect the integrity of everyone else. It is, therefore, the duty of society to provide everyone with equal opportunities for his or

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<sup>5</sup> Ibid., p.11.

<sup>6</sup> Ibid., p.5.

her happiness. If this could be achieved, the result would be a peaceful and united society.

The Shari‘a consists of rules and regulations governing the affairs of human beings and providing guidance in assessing their conduct according to the following categories:

1. *Wajib* (imperative): the performance of an action is compulsory and its omission is punishable.
2. *Mandub* (recommended): although it is not compulsory, its performance will be rewarded. However, its omission is not punished.
3. *Mubah* (permissible): performance will not be rewarded, yet omission will not be punished either.
4. *Makruh* (reprehensible): although performance carries religious disapproval, it will not be punished.
5. *Haram* (forbidden): actions punishable by God.<sup>7</sup>

### **1.2.2 The Nature of the Shari‘a**

The Shari‘a represents the system of God’s commands for Muslim society. However, since it is not provided ready-made, it needs human participation to interpret the sources of law. Historically, the Shari‘a has been developed by Muslims referring to textual evidence in the Qur’an and Sunna rather than being guided by their intuition.

The Shari‘a itself is not the law that is interpreted, but the sources of that law. The divinity of the Shari‘a is contained in the sources of law, which are the raw material for qualified jurists to understand, interpret and apply as required. Both the Qur’an and the Sunna of the Prophet are the ultimate sources. This interpretation is known as

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<sup>7</sup> Ibid., pp.50–51.

*ijtihad*, in which a jurist derives or formulates a rule of law based on the evidence found in the sources.

The end product of human understanding is known as *fiqh*, the Islamic positive law, which differs markedly from the Shari'a. The word "Shari'a", which is commonly translated into English as Islamic law or Islamic jurisprudence, has sometimes been confused with the term *fiqh*, which means knowledge, intelligence and understanding. Although the two terms are closely interrelated, they are different in that the Shari'a is the divine law, whereas *fiqh* is the product of human understanding and the use of intelligence in deducing the spirit and wisdom of the principal sources.<sup>8</sup> The differences between the Shari'a and *fiqh* are between the divine law as it is and the divine law as human beings understand it.<sup>9</sup> *Fiqh* is the work of human beings and is elaborated by them according to their own understanding and application of the Shari'a to particular circumstances. It follows, therefore, that a jurist or *faqih* (plural – *fuqaha*), who interprets the Shari'a, must be capable of making independent judgements, since *fiqh* is the result of an independent exercise of the intellect in deciding a point of law. Faruki also states:

The Qur'an contains the Shari'a of Muslims, but when Muslims seek to understand the Shari'a and apply understanding of the Shari'a to any particular matter, regardless of how sincere and intelligent and powerful they may be, their conclusions are no longer the same, flawless, immutable, pure Shari'a of the Qur'an but have become, inevitably, the human interpretations of Shari'a, namely, *fiqh*.<sup>10</sup>

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<sup>8</sup> Kamali stresses that *fiqh* is "knowledge of the practical rules of Shari'a acquired from the detailed evidence in the sources. ...The knowledge of the rules of *fiqh*, in other words, must be acquired directly from the sources, a requirement which implies that the *faqih* or jurist must be in contact with the sources of *fiqh*. Consequently, a person who learns the *fiqh* in isolation from its sources is not a *faqih*. See, Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence*, 3<sup>rd</sup> edn (Cambridge, UK: The Islamic Texts Society, 2003), p.2.

<sup>9</sup> Kemal A. Faruki, *Islamic Jurisprudence* (Karachi, Pakistan: Pakistan Publishing House, 1962), p.18.

<sup>10</sup> *Ibid.*, p.19.

In exercising human intellect and reasoning (*ijtihad*), it is to be expected that differences of opinion will arise among the *fuqaha*. These differences existed even among the Companions of the Prophet (pbuh) during his lifetime. They can be ascribed to differences in interpreting the meaning of evidence provided by the Qur'an, differences in the accessibility or acknowledgement of the Prophet's Sayings, and differences in circumstances. The result was the emergence of several schools of thought or *madhahib*, which differ in their methods of deducing principles from the sources. The four main *madhahib* are described briefly in section 1.2.4.

### **1.2.3 Sources of the Shari'a**

The sources of the Shari'a can be divided into primary (the Qur'an and Sunna – Traditions of the Prophet) and secondary (*ijma'*, *qiyas* and *ijtihad*).<sup>11</sup> These sources are acknowledged as lawful by the four main *madhahib*.<sup>12</sup>

#### **1.2.3.1 THE QUR'AN**

The Qur'an (verbal noun of the root *qara'a*) means recitation or reading.<sup>13</sup> The Qur'an is regarded as the most important source of the Shari'a. It consists of manifest revelation (*wahy zahir*), defined as the communication from God to Prophet Muhammad via the angel Jibril over twenty-two years.<sup>14</sup> In Islamic teachings, the Qur'an is the Word of God. Even Muslim jurists themselves have differed over the legal significance of many Qur'anic verses, because the rules in the Holy Book are

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<sup>11</sup> Doi, op. cit., p.64. Abdul Mannan states that the four basic sources of the Shari'a are the Qur'an, Sunna, *ijma'* and *qiyas* and *ijtihad*. See, Muhammad Abdul Mannan, *Islamic Economics: Theory and Practice* (Kent, UK: Hodder and Stoughton, 1986), p.28.

<sup>12</sup> Abdul Mannan, op. cit., p.36.

<sup>13</sup> Kamali, op. cit., p.16.

<sup>14</sup> According to Doi, op. cit., p. 51: "The Qur'an is not meant to be a book of law or a book of history or sociology. It is, as a matter of fact, a book of guidance where Allah speaks to his creatures to lead a decent and refined life. The Qur'an does not settle the question arising from diverse categories, as systematic and moral theology, ritual civil and military law."



revealed as general principles or a broad outline rather than specific details, and thus designed to give eternal guidance.<sup>15</sup> Nevertheless, there are verses that provide a detailed ruling on certain matters.<sup>16</sup> The *fuqaha* have unanimously agreed that the authenticity of the entire text of the Qur'an has always been proved by universally accepted (*mutawatir*) indications.<sup>17</sup>

### 1.2.3.2 THE SUNNA

The Sunna is the second primary source of the Shari'a and means a clear path or a beaten track.<sup>18</sup> Kamali states that according to the 'ulama' of Hadith, the Sunna refers to "all that is narrated from the Prophet (peace be upon him), his acts, his sayings and whatever he has tacitly approved plus all the reports which describe his physical attributes and character."<sup>19</sup>

Therefore, the Sunna represents the practical aspects of the Qur'an, as demonstrated by the Prophet and generally accepted by Muslims. Not only was the Prophet a perfect human being, but also, as the Messenger of God, he did not make any errors in matters of religion or the Shari'a. The Hadith (Traditions) is the documented part

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<sup>15</sup> Kamali, op. cit., pp. 16–55.

<sup>16</sup> Ibid. Kamali asserts: "The Qur'an also contains detailed rules on family matters, the prohibited degrees of relationship in marriage, inheritance and specific punishments for certain crimes. These rules have a devotional (*ta'abbudi*) aspect and are part of the *ibadat*. They are also associated with human nature and regulate the manner in which man's natural needs may be fulfilled. The basic objectives of the law regarding these matters are permanent. They are, however, matters that lead to disputes. The purpose of regulating them in detail is to prevent conflict among people. The specific rulings of the Qur'an in these areas also took into consideration the prevalence of certain entrenched social customs of Arabia, which were overruled and abolished. Qur'anic reforms concerning the status of women, and its rules on just distribution of property within the family could, in view of such custom, only be effective if couched in clear and specific detail."

<sup>17</sup> Ibid., p. 21.

<sup>18</sup> Ibid., p. 58. Kamali states that the term has been used to refer to normal practice or an established course of conduct. It may be a good or a bad example and it may be set by an individual or a community. He also points out that in pre-Islamic Arabia, the Arabs used the term to refer to the ancient and continuing practices of the community, which they inherited from their forefathers.

<sup>19</sup> Ibid.

of the Sunna, and the literature is extensive, covering a far wider range of issues than the legal verses in the Qur'an. It provides the practical aspect of much of the Shari'a. The following six canonical collections of hadiths were compiled during the latter half of the third century AH and are recognized as authoritative:

- *Sahih al-Bukhari* (d. 256 AH/870 AC)
- *Sahih Muslim* (d. 261 AH/875 AC)
- *Sunan Ibn Majah* (d. 273 AH/887 AC)
- *Sunan Abu Daud* (d. 275 AH/888 AC)
- *Jami' al-Tirmidhi* (d. 279 AH/892 AC)
- *Sunan al-Nasa'i* (d. 303 AH/915 AC)<sup>20</sup>

### **1.2.3.3 IJMA'**

*Ijma'* is the verbal noun of the Arabic root *ajmaa*, which means both to determine and to agree upon something.<sup>21</sup> Technically, *ijma'* is defined as the unanimous agreement of the Umma's jurists at any time on any matter.<sup>22</sup> In this way, *ijma'* ensures the correct interpretation of the Qur'an, the clear understanding and accurate transmission of the Sunna, and the legitimate use of *ijtihad*.<sup>23</sup> Unlike the Qur'an and Sunna, *ijma'* is a rational proof, since it is not a part of divine revelation.

### **1.2.3.4 QIYAS AND IJTIHAD**

*Qiyas* means the measurement or determination of the size, quantity or quality of an item. It also means the comparison of one item to another, similar, item.<sup>24</sup> In the Shari'a, it is defined as analogical reasoning, in which the ruling applied to a parti-

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<sup>20</sup> Doi, op. cit., p.54.

<sup>21</sup> Kamali, op. cit., p.229.

<sup>22</sup> Ibid., p.230.

<sup>23</sup> Ibid., p.231.

<sup>24</sup> Ibid., p.264.

cular case is analysed and used for a new, similar case.<sup>25</sup> *Ijtihad*, however, means the exercise of one's intellect to reach a judgement.<sup>26</sup> Technically, it means the use of one's human intellect to explain and elaborate on the Shari'a.<sup>27</sup>

Doi defines *qiyas* as:

the legal principle introduced in order to derive [*sic*] at a logical conclusion of a certain law on a certain issue that has to do with the welfare of the Muslims. In exercising this, however, it must be based on the Qur'an, Sunna and *Ijma'*.<sup>28</sup>

According to Kamali:

*Qiyas* has always been seen as the main vehicle of *ijtihad*, so much so that Imam al-Shafi'i considered *qiyas* and *ijtihad* as two words with the same meaning. A substantive principle of *usul al-fiqh*, *qiyas* really ranks third among the hierarchy of proofs next to the Qur'an and the Sunna. *Ijma'*, although given third place in the hierarchy of proofs, is basically a procedural, rather than substantive, principle and, important as it is, it has no methodological juristic corpus of its own.<sup>29</sup>

The use of one's reason and judgement to determine a course of action is called *ijtihad*, and the decisions made in this way are known as *ijma'*. When making decisions, it is important to take account of earlier discussions and opinions and the reasons for the conclusions reached, as well as applying a general sense of justice.<sup>30</sup> Therefore, *qiyas* is the legal method of extending the law beyond what is stated in the authoritative sources or it is an extension of a precedent. Nevertheless, it is not the establishment of a fresh ruling.

Legal reasoning is indeed essential in instances where textual evidence is not available. Apart from a small number of cases where the Qur'an and Sunna provide

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<sup>25</sup> Ibid.

<sup>26</sup> Doi, op. cit., p.78.

<sup>27</sup> Ibid.

<sup>28</sup> Ibid., p.70.

<sup>29</sup> Kamali, op. cit., p.298.

<sup>30</sup> Mervyn K. Lewis and Latifa Algaoud, *Islamic Banking* (Cheltenham, UK: Edward Elgar, 2001), p.23.



clear legal rules, most branch cases are derived from legal reasoning.<sup>31</sup> The justification for this approach is that written texts are limited, whereas the incidents of daily life are unlimited. Abdul Mannan states:

In the early centuries of Islam, *ra'y* (personal opinion) was the basic instrument of *ijtihad*. But when the principles of law were systematically laid down, it was replaced by *qiyas*. The Qur'an and Sunna, no doubt, provide us with the legal rules with regard to the individual and social life of the Muslims. But human life, living dynamics, requires law that ought to change with the changing circumstances. Hence the necessity of *ijtihad*.<sup>32</sup>

Since *qiyas* is based on precedent, it requires the comparison of two cases, in which one is evaluated in the light of the other. An example is that the use of narcotics is *haram* (forbidden), the ban in this case being based on the same principle as the ban on the consumption of alcohol. To reach a correct decision, scholars access subsidiary sources such as *qiyas* (analogical reasoning), *maslaha mursala* (unrestricted public interest) and *'urf* (customary practice). Of these sources, *qiyas* is the most important and workable instrument. However, although the majority of scholars supported the application of *qiyas*, there were some jurists who opposed it, such as Ibn Hazm.<sup>33</sup>

#### **1.2.4 The Four Main Schools of Legal Thought (*Madhahib*)**

The four main schools had emerged within the orthodox Sunni tradition by the tenth century AC, whereas the Shi'a had established their own schools.<sup>34</sup> These four schools, each with its own system of theory and application of law, are as follows:

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<sup>31</sup> Abdul Mannan, op. cit., p.34.

<sup>32</sup> Ibid.

<sup>33</sup> Kamali, op. cit., pp.268–301. He states that the argument against the use of *qiyas* was advanced mainly by the Zahiri School and some Mu'tazilites, including their leader, Ibrahim al-Nazzam. The leading Zahiri jurist, Ibn Hazm (d. 456/1064), was the most outspoken opponent.

<sup>34</sup> Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh, UK: Edinburgh University Press, 2000), p.33. According to Lewis and Algaoud, "The most important sectarian division in Islam is the one which separates Sunni and Shi'a believers, which arose

1. Hanafi: founded by Abu Hanifah (80/699–150/767)
2. Maliki: founded by Malik Abu Anas (95/713–179/795)
3. Shafi'i: founded by Muhammad ibn Idris al-Shafi'i (150/767–204/820)
4. Hanbali: founded by Ahmad ibn Hanbal (169/780–241/855)

In addition, other *fiqh* schools were founded during the same period by scholars such as Dawud ibn 'Ali, al-Awza'i, Sufyan al-Thawri and Abu Thawr.<sup>35</sup> Warde describes these schools as follows:

The legal methodologies of these schools differ, combining different proportions of textual authority and analogical reasoning: the Hanbalis tend to adhere to literal interpretations of religious texts, while Malikis and Hanafis allow wider discretion in the interpretations of such texts. On a specific issue, different schools may be clear, ambiguous or silent. They may also be lenient or strict.<sup>36</sup>

As time went by, each of the four main schools gained preference in a particular geographical area. Since the Hanafi School was once the official legal interpreter for the Ottoman Empire, most of its adherents are found in the Eastern Mediterranean countries such as Turkey, Egypt, Syria, Lebanon, Jordan and Iraq. It is also followed by the majority Sunni population of Indian Muslims, making it by far the largest school of Islamic law.<sup>37</sup> The Hanafi School is known for its endorsement of reason and logic as legitimate sources in the application of rules to the

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in 661 CE on the question of the rightful leadership of the community. Shi'ism, which has various school sub-sects, is predominant in Iran, and has significant numbers of followers in Iraq, India and many Gulf States. There are considerable doctrinal differences between the Shi'a and the four Sunni schools of Islamic law, in terms of who is permitted to interpret Shari'a law. Shi'ites believe that living religious scholars, known as *mujtahids*, have an equal right to interpret Divine Law as eminent jurists of the past, and their judgements replace the Sunni source of deduction by analogy, *qiyas*." See, Lewis and Algaoud, op. cit., p.23.

<sup>35</sup> Abdul Mannan, op. cit., p.37.

<sup>36</sup> Warde, op. cit., p.33.

<sup>37</sup> Ibid.

practical questions of life. It is also considered the most flexible and workable school for commercial transactions.

The adherents of the Maliki School are concentrated in the western region of the Muslim world, particularly in North and West Africa.<sup>38</sup> The School was established as a result of the founder's legal doctrines bound by the practices of the Madinans as well as analogical deduction to reach a ruling for cases not covered by the Qur'an or the Sunna.

The adherents of the Shafi'i School are to be found mainly in Indonesia, Malaysia, Yemen, Sri Lanka, East Africa and parts of Egypt. Imam Shafi'i had a thorough knowledge of the doctrines of the Maliki and Hanafi Schools.<sup>39</sup> Unlike the Hanafi School, the Shafi'i School was not concerned with the flexible and worldly areas of law. Indeed, Imam Shafi'i held the view that the Sunna of the Prophet explained the meaning of the Qur'an.

The adherents of the Hanbali School can be found in Saudi Arabia.<sup>40</sup> Its founder, Ibn Hanbal, compiled a work on the Sunna, which became the basis of juridical decisions made by later Hanbali jurists.

Although the four main schools place different levels of emphasis on the sources of law, yet they all agree on the requirement that the Shari'a be God-given, not created by human beings. Therefore, the Qur'an and the Sunna are fully binding, while the other sources of authority are justified by reference to these two basic sources.<sup>41</sup>

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<sup>38</sup> Ibid.

<sup>39</sup> Ibid.

<sup>40</sup> Ibid.

<sup>41</sup> Lewis and Algaoud, *op. cit.*, p.24.

### 1.3 The Concept and Prohibition of *Riba*

From the perspective of Islamic scholars, *riba* is not only unethical but also distorts community development. It erodes and destroys individual wealth, leading to unethical behaviour and a class system within the community, ultimately creating conflict within society. Furthermore, *riba* results in the rich becoming richer and the poor becoming poorer in such a way that the poor will have to borrow from the rich, who always have excess savings. The poor are penalized by the obligation to pay interest on their loans, while the rich cream off the interest, and so the vicious circle continues. In short, *riba* creates the unjustified enrichment of one party at the expense of another.

It has been stated by Schacht that *riba* is a special case of unjustified enrichment or, in the words of the Qur'an, consuming (that is, appropriating for one's own use) the property of others for no good reason, which is prohibited.<sup>42</sup> Divine notes that the theoretical grounds on which the prohibition of *riba* is based already existed in earlier sources: Plato and Aristotle. He points out that the reasons for their condemnation of usury were as follows:

(1) that as a form of "money-making" it was a degrading occupation, distorting the true function of economic enterprise by seeking gain rather than the satisfaction of wants, making of money an end in itself and so distracting the citizen from the practice of virtue, which was his first duty; (2) that it was a particularly degrading form of money-making, contrary to the liberality and generosity which the rich should practise towards the poor; and (3) that on this account it was inimical to the welfare of the state, destroying peace and concord by setting one class against the other. To these three, Aristotle added (4) that of its very nature, it was a violation of justice.<sup>43</sup>

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<sup>42</sup> Schacht, op. cit., p.145.

<sup>43</sup> Thomas F. Divine, *Interest: An Historical and Analytical Study in Economics and Modern Ethics* (Milwaukee, WI: Marquette University Press, 1959), pp.18–19.

In Islam, justice is one of the most important factors influencing the ideal Muslim society, for it covers every aspect of human interaction: social, economic and political. Concerning economics and business transactions, Islam lays particular emphasis on the establishment of justice<sup>44</sup> and the elimination of exploitation. Thus, it prohibits all forms of unjustified enrichment, of which *riba* represents one of the main sources.<sup>45</sup> A full understanding of the prohibition of *riba* is essential for the appreciation of the true spirit of Islamic economics, for this rule represents the endeavour of the Shari'a to achieve socio-economic justice in Muslim society.

The prohibition of *riba* is clearly stated in Islamic teachings from the Qur'an and the Sunna, and it is generally accepted by the schools of thought in the Shari'a.<sup>46</sup> Nevertheless, each school of legal thought has a different view of *riba* and it is one of the topics most debated by the *fuqaha* and Islamic scholars.<sup>47</sup>

It should be noted that the prohibition of *riba* applies not only to Muslims, for, historically, Jews and Christians were also prohibited from participating in any aspect of interest. In Christianity, the Bible, the patristic writings, and the Church

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<sup>44</sup> Justice ('*adl*') is one of the fundamental principles of Islam, encompassing a comprehensive system of accountability that is an important means of eradicating inequity, exploitation and all other forms of wrongdoing. See, Muhammad Umer Chapra, *Towards a Just Monetary System* (Leicester, UK: The Islamic Foundation, 1985), pp.27–28. According to Kamali, "'*adl*' literally means putting something in its rightful place as well as giving others equal treatment or reaching a state of equilibrium in transactions with them. He explains further: "'*Adl*' thus signifies moral rectitude and fairness since it means that things should be where they belong. Justice is closely related to equality in that it aims for a state of equilibrium in the distribution of rights and duties, and advantages and burdens in the community. Justice and equality are, however, not identical in the sense that, under certain circumstances, justice may only be achieved through inequality or an equal distribution of wealth. Justice is, in many ways, a universal concept in that its basic meaning does not seem to vary a great deal between the major legal traditions of the world." See, Mohammad Hashim Kamali, *Freedom, Equality and Justice in Islam* (Cambridge, UK: The Islamic Texts Society, 2002), p.103.

<sup>45</sup> Ibid., p.55.

<sup>46</sup> Nabil A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba', Gharar and Islamic Banking* (Cambridge, UK: Cambridge University Press, 1986), pp.1–13.

<sup>47</sup> Ibid.



Councils all prohibited usury historically.<sup>48</sup> Indeed, the Christian Church considered the practice of taking and giving usury a major sin. Noonan points out: “The usury analysis would not have begun if the Church had not prohibited usury, and no other intellectual or economic force exerted so strong a pressure on the formation of the early theory.”<sup>49</sup>

As a result of the expansion of trade and business during the twelfth century, the Church itself began to examine interest more closely.<sup>50</sup> In the eighteenth century, more forms of credit were accepted by the Catholic Church. Between 1822 and 1836, the Holy Christian Office in Rome declared that all forms of interest permitted by civil law could be accepted by everyone. Finally, in 1950, Pope Pius XII approved the banking system for the Roman Catholic Church, declaring that bankers “earn their livelihood honestly”.<sup>51</sup>

Concerning Jews, Saleh states: “Jews are prohibited by their religious law from charging their co-religionists interest (Exodus XXII:25; Leviticus XXV:36, 37). This prohibition does not apply to transactions with adherents of other religions.”<sup>52</sup> His argument is similar to that of Diwany, who says that many Jews interpreted the prohibition of usury as applying to loans made between Jews, not between a Jew and

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<sup>48</sup> John T. Noonan, Jr, *The Scholastic Analysis of Usury* (Cambridge, MA: Harvard University Press, 1957), p.11. Vadillo also asserts that among the Romans, Seneca and Cicero argued vehemently against usury, and among the early Fathers of the Christian Church, Gregorius Nysennas, Juan Christostomos, Augustine and Thomas Aquinas, were similarly opposed. See, Umar Vadillo, *The End of Economics* (San Gregorio Alto, Granada: Madinah Press, 1991), p.14.

<sup>49</sup> Ibid.

<sup>50</sup> Divine, op. cit., p.36.

<sup>51</sup> Sidney Homer, *A History of Interest Rate* (New Brunswick, Canada: Rutgers University Press, 1987), p.81.

<sup>52</sup> Saleh, op. cit., p.9.



a Gentile, although the prohibition of usury appears in the Torah and the Bible.<sup>53</sup>

Thomas Aquinas (1225–1274) stated the following about the prohibition of usury in Judaism:

The Jews were forbidden to take usury from their brethren, i.e., from other Jews. By this, we are given to understand that to take usury from any man is simply evil, because we ought to treat every man as our neighbor and brothers, especially in the state of Gospel, whereto all are called ....They were permitted, however, to take usury from foreigners, not as though it were lawful, but in order to avoid a greater evil, lest, to wit, through avarice, to which they were prone, according to Is. Lvi : II, they should take usury from Jews, who were worshippers of God.<sup>54</sup>

### 1.3.1 The History of Interest

The earliest known historical record of the giving and taking of interest is that of the Sumerians in Mesopotamia (3000–1900 BC), a society in which trade played an important part. According to Homer, barley was the medium of exchange for most transactions, although copper and silver were also used.<sup>55</sup> Money in the form of coins came into existence only in the first millennium BC. The Sumerians already practised systems of property ownership and credit. Under the credit system,<sup>56</sup> loans of barley were based on quantity and those of silver on weight. Interest charged on loans of barley was 33⅓ per cent per annum, and on silver, 20 per cent per annum.<sup>57</sup>

The rates of interest introduced by the Sumerians were formally accepted and legalized by the Code of Hammurabi – established by the King of Hammurabi c.

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<sup>53</sup> Tarik el-Diwany, *The Problem with Interest* (London: Ta Ha Publishers, 1997), p.26.

<sup>54</sup> Benjamin N. Nelson, *The Idea of Usury* (Princeton, NJ: Princeton University Press, 1949), p.14.

<sup>55</sup> Homer, op. cit., p.25.

<sup>56</sup> Ibid., pp.4–5. Homer points out: “Credit is sometimes considered a modern devise or even a modern vice. It is true that a few credit forms have been developed in our century and the statistics reflecting the growth of the volume of credit during recent decades are impressive. But a glance through the pages of financial history will dispel the notion of novelty. Credit was in general use in ancient and in medieval times. Credit long antedated industry, banking and even coinage; it probably antedated primitive forms of money.”

<sup>57</sup> Ibid., p.29

1800 BC – during the Babylonian period. This system continued for more than 1,200 years.<sup>58</sup> According to Homer, many of the financial customs practised by the Sumerians became established in this way.<sup>59</sup> The taking and giving of interest continued during the later empires of the Assyrians (732–625 BC), the Neo-Babylonians (625–539 BC), Persians (539–333 BC), Greeks (500–100 BC) and Romans (500–400 BC).

Despite the Church's strong stand against usury, however, its prohibition was largely ignored by business. Thus, the operations of the newly emerging modern banks were based on interest, creating a banking system that has continued to this day. The argument has been put forward that if interest were removed from the banking system, then the whole economy would be paralyzed.<sup>60</sup>

### **1.3.2 The Meaning of Interest, Usury and *Riba***

It is important to clarify the differences in the meaning of the terms “interest”, “usury” and “*riba*”. For example, Saleh points out: “*Riba* is generally translated into English as ‘usury’ or ‘interest’, but in fact has a broader sense under Shari‘a, as already suggested by its dictionary meaning, which is ‘increase’ or ‘gain’.”<sup>61</sup> According to *The Concise Oxford Dictionary* (2004), interest is “money paid for the use of money lent or for not requiring the repayment of a debt”, while usury is “the practice of lending money at unreasonably high rates of interest.” The use of the terms “interest” and “usury” today differs from that of earlier times, and this distinction is discussed below.

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<sup>58</sup> Ibid., p.30.

<sup>59</sup> Ibid., pp.26–27.

<sup>60</sup> Abdul Mannan, op. cit., p.162.

<sup>61</sup> Saleh, op. cit., p.13.

### 1.3.2.1 DEFINITIONS OF INTEREST

The Western concept and use of the term “interest” originate in Roman Law. Interest here means money to be paid to the creditor as compensation for the loss incurred in making the loan.<sup>62</sup> According to Divine, *id quod interest* means the compensation for damage or loss suffered by the creditor, owing to the debtor’s failure to repay the loan on the date specified in the contract.<sup>63</sup> The payment of compensation might be included as a clause in the original contract or it might be the subject of a claim after the contract has expired.

Homer states that the modern term “interest” is derived from the Latin verb *intereo*, which means “to be lost”.<sup>64</sup> He adds that a substantive form *interisse*, which became standard around 1220, evolved into the modern term “interest”.<sup>65</sup> Homer notes that the meaning of “damages” covered by interest could be sufficiently broad to include the profit that the lender could have made with the money loaned.<sup>66</sup>

These findings confirm that interest always implied a loss rather than a profit, that is, the loss incurred by the creditor as a result of lending the money to the debtor. Historically, interest has been regarded as compensation paid by the debtor for failing to fulfil the requirements of the contract. Therefore, interest is regarded not as part of the repayment of a loan, but as a payment for damage or loss incurred by the creditor.

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<sup>62</sup> Noonan, op. cit., p.105.

<sup>63</sup> Divine, op. cit., p.3.

<sup>64</sup> Homer, op. cit., p.73.

<sup>65</sup> Ibid.

<sup>66</sup> Ibid.

### 1.3.2.2 DEFINITIONS OF USURY

The word “usury” is derived from the Latin *usura*, and there also exists the synonym *foenus*. The Greek equivalent is *tokos*, which means “issue” or “produce”.<sup>67</sup> In the historic context of a loan, usury meant the payment for the use of the money itself, or, more broadly speaking, for the loan of any goods classified as *mutuum* (Latin), that is, “fungible” (moveable or consumable) goods. However, since the majority of loans were made in the form of money, usury acquired its present meaning of an exorbitant charge or a charge higher than the legal rate for a monetary loan.<sup>68</sup> When Roman jurists referred to *mutuum* or *foenus*, they did not mean interest, for *usura* was the term used to describe a payment above the principal.<sup>69</sup>

Among the early Christians who prohibited their followers from practising usury was St Ambrose (d. 397). He wrote: “What exceeds the amount loaned is usury, whether the loan is of money, of foods, of raiment or of any other types of goods.”<sup>70</sup> St Jerome (d. 420) likewise defined usury as the acceptance of anything more than the amount loaned (whether monetary or not).<sup>71</sup> St Augustine (d. 371) gave a similar definition: “The usurer is he who expects to receive more than he has given, whether of money or of corn or of wine or of oil or of anything else.”<sup>72</sup> The Nynweger capitulary 806, which contains the earliest known mention of usury from medieval times, also defines usury as “where more is asked than is given”.<sup>73</sup> According to Noonan, the words of St Augustine, St Jerome and St Ambrose, as well

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<sup>67</sup> Divine, op. cit., pp.3–4.

<sup>68</sup> Ibid.

<sup>69</sup> Noonan, op. cit., p.105.

<sup>70</sup> Divine, op. cit., p.30.

<sup>71</sup> Ibid.

<sup>72</sup> Ibid., p.31.

<sup>73</sup> Noonan, op. cit., p.15

as the Nynweger statute under the erroneous title of the Council of Agde, prove that usury is “whatever is demanded beyond the principal”.<sup>74</sup>

The early medieval campaign against usury reached its peak during the twelfth century. Pope Alexander III (1159–1181) declared that credit sales that were higher than the original cash price should be classified as usury.<sup>75</sup> According to Noonan, this was the earliest instance where the meaning of usury was extended to include certain transactions that were not explicit loans. Pope Urban III (1185–1187) quoted the words of Christ: “Lend freely, hoping nothing thereby” (Luke 6:35).<sup>76</sup> This was the first time in the whole history of Christianity that a specific command of Christ was interpreted by a Pope as the authoritative prohibition of usury.<sup>77</sup>

### **1.3.2.3 DEFINITIONS OF *RIBA***

Schacht says that the literal meaning of *riba* is “increase”. As a technical term, it is translated into English as usury and interest, and, in general, any unjustified increase of capital for which no compensation is given. Derivatives from the same root are

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<sup>74</sup> Ibid., p.16. Noonan, Ibid., p.18, also states that “One citation from St Augustine points out that usuries, as stolen goods, may not be given as charity- a restriction which emphasizes the unjust character of their acquisition”

<sup>75</sup> Ibid., p.19.

<sup>76</sup> Ibid.

<sup>77</sup> Ibid., p.20.

used in other Semitic languages to describe interest.<sup>78</sup> According to al-Zuhayli, the lexical meaning of *riba* is an increase in number, amount, etc.<sup>79</sup> Haque states that the word *riba* is derived from the root *rbw*, meaning to increase, grow or augment.<sup>80</sup> He adds:

The fourth form (*arba*) means to make grow, increase or augment, i.e., a certain person engaged in, took or practised *riba*. The verbal noun *riba* thus means excess (*ziyada*), increase, augmentation, expansion or growth (*nama*). An elevated place or hill is called *rabwa* for its excessive increase in height over the adjacent places. This increase (*ziyada*) originates either in the thing itself, or in an exchange or sale (*muqabala*) of moneys or commodities, as the sale of one dirham for two dirhams.<sup>81</sup>

Haque concludes, therefore:

*Riba* occurs either in a thing, commodity or money, as the loan of a sum of money or a commodity to be returned with an increase; or in an unjust or inequitable sale/exchange when the exchange of one commodity against another brings with it an increase in the commodity. In the technical/legal terminology of the Shari'a, *riba* has therefore been defined as an increase or excess (*fadl*) which, in an exchange or sale of commodity, accrues to the owner (lender) without giving in return any equivalent counter-value, or recompense, '*iwad* (to the other party).<sup>82</sup>

The following are some definitions given by various scholars of the term *riba*.

Chapra says that according to the Shari'a, *riba* technically refers to the "premium"

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<sup>78</sup> Joseph Schacht (1995), "*Riba*", in *Encyclopedia of Islam*, ed. C.E. Bosworth, E. van Donzel, W.P. Heinrichs and G.Lecomte (Leiden, The Netherlands: E.J. Brill, 1995), p.491. The Qur'anic meaning of *riba* is cognate to the Hebrew word *ribbith*, which means "increase" and "interest". See, Stephen M. Passamaneck, *Insurance in Rabbinic Law* (Edinburgh, UK: Edinburgh University Press, 1974), p.31. According to el-Gamal, "The basic profit-sharing principle also bears very close resemblance to the Jewish legal concept of the *heter isqa* (or *iska*, partnership clause) contract, a silent partnership profit-sharing arrangement, to avoid the Biblical prohibition of *ribbit*." See, Mahmoud A. el-Gamal, *Islamic Finance: Law, Economics, and Practice* (New York: Cambridge University Press, 2006), p.138.

<sup>79</sup> Wahbah al-Zuhayli, *al-Fiqh al-Islami wa 'Adillatuh (Islamic Jurisprudence and Its Proofs: Financial Transactions in Islamic Jurisprudence)*, trans. Mahmoud A. el-Gamal, vol.1 (Damascus: Dar al-Fikr, 2003), p.309.

<sup>80</sup> Ziaul Haque, *Islam and Feudalism: The Economics of Riba, Interest and Profit* (Lahore, Pakistan: Vanguard Books, 1985), p.16.

<sup>81</sup> Ibid.

<sup>82</sup> Ibid. Haque states that '*iwad* is "the basic trait or the *conditio sine quo non* of the *halal* or lawful sale, because sale is necessarily an exchange of value against an equivalent value; an equitable return and compensation for the goods or services exchanged."



that must be paid by the borrower to the lender, together with the principal amount as a condition for the loan or for an extension on its maturity.<sup>83</sup> Schacht's formal definition of *riba* is "a monetary advantage without a counter-value, which has been stipulated in favour of one of the two contracting parties in an exchange of two monetary values."<sup>84</sup> Saleh says:

*Riba* in its Shari'a context, can be defined, as generally agreed, as unlawful gain derived from the quantitative inequality of the counter-values in any transaction purporting to effect the exchange of two or more species which belong to the same genus (*jins*) and are governed by the same efficient cause (*'illa*, plural *'ilal*). Deferred completion of the exchange of such species, or even of species which belong to different genera but are governed by the same *'illa*, is also *riba*, whether or not the deferment is accompanied by an increase in any one of the exchanged counter values.<sup>85</sup>

*Riba* is defined by Sayyid Abul A'la Mawdudi (d. 1979) as the "predetermined excess or surplus over and above the loan capital received by the creditor conditionally in relation to a specified period".<sup>86</sup> This definition contains the following three elements:

1. Excess or surplus over and above the loan capital (that is, the principal).
2. Determination of this surplus in relation to time.
3. Bargain to be conditional on the payment of a predetermined surplus to the creditor.

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<sup>83</sup> Chapra, op. cit., p.56.

<sup>84</sup> Schacht (1984), op. cit., p.145.

<sup>85</sup> Saleh, op. cit., p.13. According to Saleh, "efficient cause" is possibly the nearest English translation of *'illa*. However, since there is no entirely satisfactory English equivalent, the Arabic term is used. He states that the prohibition of *riba* applies principally to the two precious metals (gold and silver) and four commodities (wheat, barley, dates and salt), to all species (*anwa'*, singular *naw'*), which are jointly governed by the same efficient cause (*'illa*) or belong jointly to any one of the genera (*ajnas*, singular *jins*) to which the six articles named in the Tradition are subordinated. He defines genus (*jins*) as a class of articles containing several subordinate classes or species; and species (*naw'*) is defined as a group of articles having certain common attributes or qualities, subordinate to a genus.

<sup>86</sup> Sami H. Homoud, *Islamic Banking: The Adaptation of Banking Practice to Conform with Islamic Law* (London: Arabic Information, 1985), p.47.

### 1.3.3 The Differences between *Riba* and Trade (*Bay'*)

*Riba* is different from trade.<sup>87</sup> The practice of giving a loan to increase capital without any commodity exchange is considered unjust to the borrowers, for the money is considered to increase its own value without being used in the economic activity of a just sale or exchange.

Haque notes the differences as follows:

The jurists thus clearly hold that, unlike just *bay'*, *riba* implies that money or a commodity is loaned or exchanged for self-generating or self-expanding value, which is not a form of just sale because the increment over the exchanged or loaned commodity or principal capital does not bring in return any equivalent counter-value to the borrower. For them, this growth or increase (*fadl*) of money or commodity in loans (as well as in "sales" and exchange in the broad sense) is illegal and inequitable. In a *bay'*, i.e., exchange of equal values, there is a purchase and a sale, i.e., a permissible equal change, a just and lawful economic activity, a fair transaction, since something is exchanged for something, an equal value for an equal value, as money for goods, or simply goods for goods.<sup>88</sup>

However, profit cannot be eliminated from trade, for they are interrelated.

Homoud states that profit means growth by trading.<sup>89</sup> In his interpretation of the

Qur'anic verse (*Surat al-Baqarah* 2:16), al-Tabari refers to trade and profit as

The merchant who receives a profit for the commodity of which he owned a substitute, which is either more valuable than the commodity he owned, or greater than the price which he sold it for. However, he who receives for his commodity a substitute which is less than what he had before or lower than the price for which he sold it is undoubtedly the loser in his commerce.<sup>90</sup>

As has been pointed out by Homoud, revenue that is surplus to the capital cannot be called profit unless it is coupled with work, and unless the surplus is the result of an

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<sup>87</sup> According to Abdullah Yusuf Ali, *bay'* (literally, sale or barter) is also used more generally for trade and commerce and various kinds of transactions. See Abdullah Yusuf Ali, *The Holy Qur'an, Text, Translation and Commentary* (Lahore, Pakistan: Shaikh Muhammad Ashraf Kashmiri Bazar, 1937), p.111.

<sup>88</sup> Haque, op. cit., p.19.

<sup>89</sup> Homoud, op. cit., p.135.

<sup>90</sup> Abu Ja'far Muhammad Jarir al-Tabari, *The Commentary on the Quran*, ed. J. Cooper, Wilferd F. Madelung and Altan Jones (Oxford, UK: Oxford University Press, 1987), p.139.

exchange that has transformed the capital from one state into another.<sup>91</sup> However, if the revenue is the result of using the financial commodity without any transformation, then it is called a wage (rental fee). In the view of Islamic jurisprudence, profit is a kind of growth of property resulting from the investment of the property in a business activity.<sup>92</sup>

Therefore, the profit is due to the human effort made in gaining it. When trading transactions take place, the money used is transformed into merchandise and then converted back into money. The traders receive a larger sum of money, which is called profit, or a smaller sum, which is called loss. Trading is exposed to business risk and the justification for this is that the property or capital concerned grows only from investment. In the words of Homoud:

The view of Islam to capital, which is clearly revealed in the rules of jurisprudence, did not determine a right for money (coins) to obtain any profit, unless it is joined, in a partnership, with work (human effort), regardless of whether the result is profit or loss.<sup>93</sup>

The Qur'an itself distinguishes between *riba* and trade, for trade brings prosperity and blessings, whereas *riba* brings anger and destruction (*Surat al-Baqara*, 2:275–276):

Those who devour usury will not stand except as stands one whom the evil one by his touch has driven to madness. That is because they say: "Trade is like usury", but God has permitted trade and forbidden usury. Those who, after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for God [to judge]; But those who repeat [the offence] are companions of the fire: they will abide therein [forever]. God will deprive usury of all blessing, but will give increase for deeds of charity: For He does not love creatures who are ungrateful and wicked.<sup>94</sup>

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<sup>91</sup> Homoud, op. cit., p.138.

<sup>92</sup> Ibid.

<sup>93</sup> Ibid.

<sup>94</sup> Ali, op. cit., pp.111–112.

Ali stresses that these verses clearly condemn and prohibit usury.<sup>95</sup> In his opinion, usury is

undue profit made, not in the way of legitimate trade, out of loans of gold and silver, and necessary articles of food such as wheat, barley, dates and salt (according to the list mentioned by the Holy Apostle himself).<sup>96</sup>

In addition, he states that usury would include profiteering of all kinds, but exclude economic credit, the creature of modern banking and finance. He also says:

While legitimate trade or industry increases the prosperity and stability of men and nations, a dependence on usury would merely encourage a race of idlers, cruel blood-suckers, and worthless fellows who do not know their own good and are therefore akin to madmen.<sup>97</sup>

The Qur'anic verses 2:275–276 were revealed after the legitimacy of the prohibition of *riba* was questioned by some of the Prophet's contemporaries.<sup>98</sup> They could not see the difference between a sale and a loan, stating that if the profit from a loan was to be forbidden, then so too should the profit from a sale.<sup>99</sup> The Qur'an responds to this view with the verses 2:275–276. Saleh also clearly distinguishes between trade and *riba*, stressing that not all profit and gain are unlawful in the Shari'a. Only *riba* is prohibited according to the various schools of law.<sup>100</sup> Therefore, although *riba* has the meaning of an increase in the value of property, it works in a different way. Concerning the *riba* in loans, Homoud says:

So long as the property is not transformed from currency (coins) into commodities or otherwise and vice versa and in the absence of any sale or purchase operations, the increase received by either party is usury. A debt owing from a debtor is neither transformed nor is it the subject of a sale or purchase (after transformation); it begins a debt, which grows in accordance with the conditions agreed; it is immaterial whether such increase is for one time or repeated times

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<sup>95</sup> Ibid., p.111.

<sup>96</sup> Ibid.

<sup>97</sup> Ibid.

<sup>98</sup> Saleh, op. cit., pp.33–34.

<sup>99</sup> Ibid.

<sup>100</sup> Ibid.



and whether it is of the same species as the principal sum of the debt or otherwise.<sup>101</sup>

Sayyid Abul A'la Mawdudi also suggests four fundamental differences between profit and *riba*:

1. In trade, exchanges between buyer and seller are based on equality. The buyer fairly obtains the item that he has purchased, and the seller gains profit in consideration of the labour, time and brainpower he utilizes in obtaining that item for the buyer. In the case of interest, there is no apportionment of profits between the two parties on the basis of impartiality. The creditor secures for himself a fixed amount of money, which he considers as his profit after giving out a loan; the debtor only acquires the time in which to use the money, and this time factor does not essentially acquire him profit.
2. In trade, however high the profit the seller might demand from the buyer, the profit is only charged once. However, in the case of interest transaction, the creditor continues to charge interest over an unsettled loan for as long as the principal amount is not returned by the debtor.
3. In trade, when a commodity is exchanged for its selling price, the transaction comes to an end. The purchaser does not give anything after that transaction to the seller. In hire transactions, whether of house, land, furniture or other material, the original remains unharmed and is later returned to the owner. In the case of interest, however, the debtor is obliged to spend the amount borrowed from the creditor, which he has to reproduce and return with the interest owed.
4. In professions relating to trade, such as craftsmanship, the individual receives the outcomes after undergoing labour, hardship, or by his skill or art. In interest

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<sup>101</sup> Homoud, op. cit., p.139.

transactions, he only lends out his money or the capital and becomes, without any personal labour or hardship, a foremost partner in the earnings of his debtor.<sup>102</sup>

The above discussions clearly show the difference between trade and *riba*. The Qur'an, too, distinguishes one from the other, allowing trade but prohibiting *riba*. It is also understood that traders/merchants are exposed to business risk, for they bear all the gains and losses, whereas the opposite is true of *riba* transactions, in which the customer gains nothing.

### **1.3.4 The Prohibition of *Riba***

In the Shari'a, the prohibition of *riba* is derived from three sources: the Qur'anic Revelation, the Traditions (Sunna) of the Prophet (pbuh), and consensus (*ijma'*).<sup>103</sup> The concept of *riba* in the Qur'an and Sunna is general and has a broad connotation. Therefore, since the death of the Prophet (pbuh), Muslim jurists have been making every effort to give a precise interpretation of *riba*, and the *fiqhi* interpretation or technical meaning continues to be debated.

#### **1.3.4.1 The Prohibition of *Riba* in the Qur'an**

The prohibition of *riba* appears in four separate revelations in the Qur'an.<sup>104</sup> The first verse was revealed in Makka and the remainder in Madina. According to Muslim scholars, there are four stages, beginning with a judgement of value, followed by an implicit prohibition, a limited prohibition, and finally, a total prohibition.<sup>105</sup> The introduction of the prohibition was gradual, so as to prepare Muslims for their

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<sup>102</sup> Sayyid Abul A'la Mawdudi, *Towards Understanding the Qur'an*, vol.1, *Surahs 1-3* (Leicester, UK: The Islamic Foundation, 1988), pp.215-216.

<sup>103</sup> Al-Zuhayli, op. cit., p.310.

<sup>104</sup> For example, see, Chapra, op. cit., p.56; Doi, op. cit., p.108; Saleh, op. cit., p.33; Homoud, op. cit., p.65.

<sup>105</sup> Saleh, op. cit., p.33.



willing compliance with the final injunction. This approach was similar to that taken with the prohibition of intoxicants, the consumption of which was widespread among the Arabs during the early years of Islam. Al-Zuhayli comments as follows:

It is well known that one of the characteristics of religious law is gradual prohibition of unacceptable conduct. For instance, the prohibition of wine proceeded in four stages, culminating in the verses (5:90–91); and the prohibition of adultery similarly progressed in two steps, first through the incarceration of women and punishment of men (5:15–16), and then through the punishment of flagellation in (24:2). Following the same gradual process, the prohibition of *riba* came in four stages.<sup>106</sup>

The revelations comprise the following four stages:

#### THE FIRST STAGE

That which you lay out for increase through the property of [other] people, will have no increase with Allah; but that which you lay out for charity, seeking the countenance of Allah [will increase]; it is these who will receive a recompense multiplied (*Surat al-Rum* 30:39).<sup>107</sup>

This verse appears to have been revealed during the early years of Prophet Muhammad's mission in Makka, possibly about 614 or 615 AC or even earlier.<sup>108</sup>

This date is based on the internal evidence of the Qur'an.<sup>109</sup>

The verse compares those who give money to earn an increase (*riba*) with those who give alms to please Allah. The Qur'an promotes the giving of alms, while discouraging loans based on interest. Homoud states that since this was a Makkan verse, it was directed at people in the early stages of Islam, encouraging them to abolish loans based on interest (*riba*),<sup>110</sup> and to give alms and charity instead. He adds that the aim of the verse was the "awakening of the live souls", addressing the

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<sup>106</sup> Al-Zuhayli, op. cit., p.340.

<sup>107</sup> Ali, op. cit., p.1062.

<sup>108</sup> Saeed Abdullah, *Islam Banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation* (New York: E.J. Brill, 1996), p.20.

<sup>109</sup> Ibid.

<sup>110</sup> Homoud, op. cit., p.66.

people who, so far, had not realized that the gain from usury was to be banned.<sup>111</sup> Homoud points out that usury is of no value to Allah, whereas alms are bound to grow and multiply.<sup>112</sup> Ali's comment on this verse is that the Qur'an condemns all unlawful grasping of wealth at other people's expense, for it clearly states that profit should be earned only by one's own efforts and at one's own expense, not by exploiting others.<sup>113</sup> *Riba* is an increase in income by unlawful means, such as usury, bribery, profiteering, fraudulent trading and so on.<sup>114</sup>

However, several early commentators on the Qur'an argue that the meaning of *riba* in this verse is "gift". Some lexicographers like Azhari (d. 370/980) and Ibn Manzur (d. 711/1311) stated that there were two types of *riba*, one prohibited and the other lawful.<sup>115</sup> According to Ibn Manzur, the Qur'anic verse (30:39) refers to lawful *riba*. He explained that lawful *riba* means "giving a person something in anticipation of getting something better at a later time."<sup>116</sup> Nevertheless, Saeed does not agree with this interpretation:

All usages of the term *riba* in the Qur'an appear to have the same meaning, that is, a charge imposed on a needy debtor due to inability to repay a debt on time. The term *riba* in the sense of gift does not appear to have been used in pre-Islamic or post-Islamic times. Neither Azhari nor Ibn Manzur provides any example of such usage. It could, therefore, be argued that the concept of a lawful *riba* and unlawful *riba* was most probably a later invention due to the difficulty the commentators had in interpreting the rather unusual wording of the verse (30:39) in which the term is used. The Qur'an here appears to be condemning the practice of *riba* and the resulting exploitation of the disadvantaged in the Meccan community.<sup>117</sup>

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<sup>111</sup> Ibid.

<sup>112</sup> Ibid.

<sup>113</sup> Ali, op. cit., p.1062.

<sup>114</sup> Ibid.

<sup>115</sup> Saeed, op. cit., p.21.

<sup>116</sup> Ibid.

<sup>117</sup> Ibid.

## THE SECOND STAGE

For the iniquity of the Jews, We made unlawful for them certain [foods], good and wholesome, which had been lawful for them, in that they hindered man from Allah's way; that they took usury, though they were forbidden; and that they devoured men's substance wrongfully; We have prepared for those among them who reject faith a grievous punishment (*Surat al-Nisa'* 4:160–161).<sup>118</sup>

These verses were revealed during the early Madinan period and strongly condemned the practice by the Jews (People of the Book) of taking *riba*. Verse 161 states clearly that those who continue this practice will be severely punished by Allah.<sup>119</sup> In these verses, a strong word has been used to indicate the beginning of prohibition, that is, “take” instead of “give”, which had been used in the earlier verse (30:39).<sup>120</sup>

Al-Qurtubi's interpretation of these verses contains two different views of the ban on usury. Firstly, he says: “God did not intend it to be the usury of the Shari'a, which was banned to us, but His intention was directed to the illegitimate property.” Then he comments: “that the laws of the prophets who preceded us contain a ban is noted and mentioned in the Book of God, which also spoke about the Jews.”<sup>121</sup>

The interpretation of these verses resulted in a misunderstanding among scholars over whether *riba* was prohibited only to the Muslims or the Jews in Madina. Philip K. Hitti, one of the great modern historians, believes that the prohibition was applied to the Madinan Jews when Prophet Muhammad needed financial support and the Jews insisted on charging interest.<sup>122</sup> Schacht also comments on these verses as follows:

The fact that the principal passages against interest belong to the Medinan period and that the Jews are reproached with breaking the prohibition, suggests

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<sup>118</sup> Ali, op. cit., p.231.

<sup>119</sup> Chapra, op. cit., p.56.

<sup>120</sup> Homoud, op. cit., p.67.

<sup>121</sup> Ibid., p.68.

<sup>122</sup> Saleh, op. cit., p.10.

that the Muslim prohibition of *riba* owes less to conditions in Mecca than to the Prophet's closer acquaintance with Jewish doctrine and practice in Medina. In the later development of the teaching on the subject as we find it in tradition, Jewish influence is in any case undeniable.<sup>123</sup>

However, although Saleh respects the opinion of Hitti and Schacht, he does not agree with them for two reasons. Firstly, discontent with *riba* arose while Prophet Muhammad was still in Makka (*Surat al-Rum* 30:39), where there were very few Jews and, in any case, they had little contact with him.<sup>124</sup> Secondly, at that time, the Jews in Madina were engaged in agriculture rather than commerce. According to Saleh, it was the Muhajirun (Makkans who migrated with the Prophet to Madina) and the Ansar (Madinan Muslims) who commonly practised *riba*.<sup>125</sup> Saleh refers to two statements by Abu Hurayra and 'Abdullah ibn Salam, Companions of the Prophet, in support of his opinion. Abu Hurayra said: "I was a poor man serving the Messenger of Allah with all of my heart while the Muhajirun and the Ansar were busy in the market caring for their fortune." 'Abdullah ibn Salam is reported to have said: "*Riba* was widespread throughout Medina, and that was interpreted as being the case after Muhammad's death and after the ejection of the Jews."<sup>126</sup>

In his interpretation of these verses, al-Tabari said:

The order of heaven is one and the same; that the usury which was banned to the Jews is the same usury which is banned to the people of Islam; that the canonical laws confirm one another, as each of them originates from God.<sup>127</sup>

He adds that the usury that was banned for the Jews was similar to pre-Islamic usury, for both consisted in taking what was surplus to the capital in consideration for an extension of the term after maturity.<sup>128</sup>

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<sup>123</sup> Schacht (1995), op. cit., p.491.

<sup>124</sup> Saleh, op. cit., p.10.

<sup>125</sup> Ibid., p.11.

<sup>126</sup> Ibid.

<sup>127</sup> Homoud, op. cit., p.68.

### THIRD STAGE

O you who have believed! Do not devour usury doubled and multiplied; but fear Allah, that you may [really] prosper (*Surah Ali 'Imran* 3:130).<sup>129</sup>

This verse was revealed in Madina, immediately after the Battle of Uhud (3/625) and almost eleven years after the first condemnation of *riba* in Makka.<sup>130</sup> Saeed states:

The verse is in the context of a reminder to Muslims of what went wrong in the battle of Uhud, when a potential victory was turned to [*sic*] a grave defeat, resulting in the death of seventy Muslim men, who left behind orphans, widows, and aged parents in need of financial support and assistance.<sup>131</sup>

In these circumstances, those in need required financial support in the form of charity, not a loan based on *riba*. Therefore, following the prohibition of *riba* transactions for Muslims, the Qur'an commands them to be God-conscious, to fear Hell, to obey God and the Prophet, and to hasten to ask for God's forgiveness. It describes the God-conscious as those "who spend in prosperity and adversity" to relieve the suffering of the needy".<sup>132</sup> In his interpretation of the verse (3:130), Ali says:

Usury is the opposite extreme of charity, unselfishness, striving, and giving of ourselves in the service of God and of our fellow man. Real prosperity consists not in greed but in living, giving ourselves and of our substance in the cause of God and God's truth and in the service of God's creatures.<sup>133</sup>

The words "doubled" and "multiplied" caused confusion among the Islamic scholars who interpreted this verse. Some understood it to mean that the prohibition applied only to the *riba* that literally doubled and multiplied. However, the majority of leading Islamic scholars agreed that the prohibition applied to all forms of *riba*

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<sup>128</sup> Ibid.

<sup>129</sup> Ali, op. cit., p.156.

<sup>130</sup> Saeed, op. cit., p.21.

<sup>131</sup> Ibid., p.22.

<sup>132</sup> Ibid.

<sup>133</sup> Ali, op. cit., p.156.

and that the amount itself was not a criterion.<sup>134</sup> Al-Tabari explained the meaning of the term in this context:

Do not consume *riba* after having professed Islam as you have been consuming it before Islam. The way pre-Islamic Arabs used to consume *riba* was that one of them would have a debt repayable on a specific date. When that date came, the creditor would demand repayment from the debtor. The latter would say, "Defer the repayment of my debt; I will add to your wealth." This is the *riba* which was doubled and redoubled.<sup>135</sup>

Clearly, this verse bans every type of *riba*, though this was not yet the formal revelation finalizing the law, which was to come in the fourth stage.

#### THE FOURTH STAGE

Those who devour usury will not stand except as stands one whom the evil one by his touch has driven to madness. That is because they say: "Trade is like usury, but Allah has permitted trade and forbidden usury." Those who, after receiving direction from their Lord, desist, shall be pardoned for the past, their case is for Allah [to judge]; but those who repeat [the offence] are companions of the Fire: they will abide therein [forever]. Allah will deprive usury of all blessings, but will give increase for deeds of charity: for He does not love ungrateful and wicked creatures. Those who believe, and do deeds of righteousness and establish regular prayers and regular charity, will have their reward with their Lord: on them shall be no fear, nor shall they grieve. O you who believe! Fear Allah and give up what remains of your demand for usury if you are indeed believers. If you do not, take notice of war from Allah and His Messenger: but if you turn back, you shall have your capital sums: do not deal unjustly, and you shall not be dealt with unjustly. If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if you remit it by way of charity, that is best for you if you only knew. And fear the Day when you shall be brought back to Allah. Then shall be every soul be paid what it earned, and none shall be dealt with unjustly (*Surat al-Baqara* 2:275–281).<sup>136</sup>

These verses were revealed towards the end of the Prophet's mission, around 8/630 or later,<sup>137</sup> and they finally established a clear distinction between trade and *riba*. Muslims were now commanded to cancel all outstanding *riba* and take only the principal amount. They should even forgo the principal if the borrower was suffering

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<sup>134</sup> Homoud, op. cit., p.69.

<sup>135</sup> Saeed, op. cit., p.22.

<sup>136</sup> Ali, op. cit., pp.111–112.

<sup>137</sup> Saeed, op. cit., p.23.



hardship.<sup>138</sup> The verses are a clear confirmation of the ban on usury already imposed in the earlier verse (*Surat Al 'Imran* 3:130) and Muslims are again given a firm reminder of the consequences of disobedience in both this world and the next. The text also implies that the prohibited *riba* can be defined as any increment to the principal.<sup>139</sup> Therefore, any extraneous addition, however small, is considered to be *riba*, and the lender should be repaid only the principal.<sup>140</sup>

#### 1.3.4.2 The Prohibition of Riba in the Sunna

According to al-Zuhayli, evidence of the prohibition of *riba* can be found in numerous hadiths of Prophet Muhammad (pbuh).<sup>141</sup> The specific details of these hadiths reinforce the general ruling stated in the Qur'an. Haque explains as follows:

The *riba*-hadiths logically seek to amplify the Qur'anic definition of *riba* (an increase of capital in loan) to cover all such increases of capital and commodities in the sector of sales/exchanges....generally termed as *ribawi* or usurious/speculative economic transactions which involve undue and unjustified profit derived from the other party, individual, group or class.<sup>142</sup>

Saleh also comments:

The Qur'anic prohibition of *riba* is [*sic*] limited to loan agreements, but soon it was to be extended by several hadiths to the exchange of currencies and denominated articles, which became property susceptible of [*sic*] *riba* (*mal ribawi*). These hadiths are reported in numerous accounts with slight differences, the one reproduced hereafter is representative of the rule that the Prophet intended to convey although it has a concise form: "[Exchange] gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, measure for measure and hand to hand. If the [exchanged] articles belong to different

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<sup>138</sup> Chapra, op. cit., p.56.

<sup>139</sup> Homoud, op. cit., p.68.

<sup>140</sup> Ibid.

<sup>141</sup> Al-Zuhayli, op. cit., pp.310–311. The author gives the following example: "Avoid the seven grave sins", among which the Prophet (pbuh) mentioned the devouring of *riba* (Hadith narrated by Muslim on the authority of Abu Hurayra). The author also states that al-Hakim narrated on the authority of Ibn Mas'ud that the Prophet (pbuh) said: "There are seventy-three different types of *riba*, the least of which is equivalent to bedding one's mother, and the worst of which is equivalent to destroying the honour of a Muslim."

<sup>142</sup> Haque, op. cit., p.67.

genera, the exchange is without restraint provided it takes place in a hand-to-hand transaction.”<sup>143</sup>

The literature on *riba* indicates that the hadiths distinguish between two types of this practice: *riba al-nasi'a* and *riba al-fadl*.<sup>144</sup> Al-Zuhayli elaborates as follows:

1. *Riba al-nasi'a*, which is the only type known to pre-Islamic Arabia. This is the *riba* collected in compensation for deferring a due debt to a new term of deferment. This definition applies regardless of the sources of the due debt: whether it resulted from a loan, or a deferred price in a sale.
2. *Riba al-buyu* (sales) for six goods (gold, silver, wheat, barley, salt, and dates). This is also known as *riba al-fadl*, which was forbidden to prevent potential circumvention of the prohibition of *riba al-nasi'a*, which can be effected by selling gold with a deferred price, which he later pays with increase containing *riba* disguised through a payment in silver.<sup>145</sup>

Al-Zuhayli explains further that it is *riba al-nasi'a* that is forbidden by the Qur'an, for it is *al-riba al-jahiliyya*. The prohibition of *riba al-fadl* was established in the Sunna by analogy to *riba al-nasi'a*, that is, an increase without due compensation.<sup>146</sup> He states that the Sunna also added the prohibition of a third type of *riba*: a deferment sale, in which the two compensations are different and one of them is deferred.<sup>147</sup> Saleh advocates that *riba* should be divided into three categories: pre-Islamic *riba* (*riba al-jahiliyya*), which was regarded as the type described in the Qur'an, and *riba al-fadl* and *riba al-nasi'a*, both of which are described in the Hadith.<sup>148</sup>

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<sup>143</sup> Saleh, op. cit., p.34.

<sup>144</sup> See, for example, al-Zuhayli, op. cit., p.311; Homoud, op. cit., p.58; Haque, op. cit., p.67; Chapra, op. cit., p.57; and Saleh, op. cit., p.13.

<sup>145</sup> Al-Zuhayli, op. cit., p.311.

<sup>146</sup> Ibid.

<sup>147</sup> Ibid.

<sup>148</sup> Saleh, op. cit., p.13.

### 1.3.4.3 *Riba in Fiqh*

Although the Qur'an does not distinguish between different types of *riba*, the Shari'a, however, refers to it in two senses: *riba al-nasi'a* and *riba al-fadl*.<sup>149</sup>

*Riba al-nasi'a* comes into effect when a specified increase is added to a loan in return for the postponement of repayment.<sup>150</sup> All the schools of Islamic jurisprudence are in solid agreement that *riba al-nasi'a* is prohibited. It is indeed one of the major sins, clearly banned by indisputable texts of the Shari'a. Hence, "the Prophet prohibited the taking of even a small gift, service or favour as a condition for the loan, in addition to the principal."<sup>151</sup> Clearly, the advance fixing of a positive return on a loan is not permitted under the Shari'a, nor does the waiting period of the repayment of a loan promise a positive return. However, if the return on the principal could be either positive or negative, depending on the final outcome of the business, which is not known in advance, it is allowed, provided that it is shared in accordance with the principles of justice laid down in the Shari'a.<sup>152</sup> Al-Zuhayli gives the following general reasons for the prohibition of *riba al-nasi'a*:

It is conducive to exploitation of the poor by the rich, and putting undue financial burdens on the needy. Moreover, permission of *riba al-nasi'a* would lead to dire economic consequences, since the resulting commodification of money and trading it in different quantities, would cause an imbalance by preventing money from serving the role of a stable numeraire. Also, in the case of foodstuffs, if profits can be made by deferment, foodstuffs may become unavailable in the markets, which may in turn lead to serious nutritional problems in society.<sup>153</sup>

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<sup>149</sup> Chapra, op. cit., p.57.

<sup>150</sup> Ibid. According to Chapra, *riba al-nasi'a* is also known as *riba al-duyun*, *riba al-mubashir* or *riba al-jali*.

<sup>151</sup> Ibid.

<sup>152</sup> Ibid., p.58.

<sup>153</sup> Al-Zuhayli, op. cit., p.321.

*Riba al-fadl*<sup>154</sup> occurs where, in an on-the-spot (hand-to-hand) transaction, there is an excess of one of the counter-values belonging to the same genus (*jins*).<sup>155</sup> According to Chapra, *riba al-fadl* does not have much influence on transactions because it occurs so rarely. Clearly, people do not aim to buy or sell an item in exchange for the same item, unless there is something extra from which each of the parties could benefit. Nevertheless, *riba al-fadl* has been prohibited because it might be used to deceive the less educated.<sup>156</sup>

*Riba al-fadl* was unfamiliar to the Arabs, unlike *riba al-nasi'a*, which had been widespread among them during the pre-Islamic era. Even the Companions were reported to hold different views of the prohibition of *riba al-fadl*. Although this type of *riba* is said to have been allowed by some of the Companions, such as 'Abdallah ibn 'Abbas,<sup>157</sup> he reportedly withdrew his judgement later and referred to the prohibition of *riba al-fadl*.<sup>158</sup> It is also prohibited by the four main legal schools of thought, despite their differing interpretations of its details and scope. However, they are in agreement on the general rulings concerning *riba al-fadl* as follows:

1. Exchange of goods of the same group and kind, such as gold for gold or dates for dates, must be equal and on the spot.
2. Exchange of goods of the same group but different in kind, such as gold for silver or wheat for barley, must be on the spot.

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<sup>154</sup> *Riba al-fadl* is also known as *riba al-buyu*, *riba al-ghayr*, *al-mubashir* or *riba al-khafî*. (See, Chapra, op. cit., p.65.)

<sup>155</sup> Saeed, op. cit., p.35.

<sup>156</sup> Chapra, op. cit., pp.242–243.

<sup>157</sup> 'Abdallah ibn 'Abbas was a cousin of the Prophet and was born in 2 BH/622 AC. He is more famous for his vast knowledge of the Traditions than for the controversial political role that he played after the Prophet's death. See, Saleh, op. cit., p.26.

<sup>158</sup> Chapra, op. cit., p.242.

3. Exchange of goods of different groups and kinds, such as gold for wheat or silver for dates, is not subject to equality or promptness (on the spot).

Saleh has simplified the position of the four main schools of legal thought on *riba al-nasi'a* and *riba al-fadl* as presented in Table 1.1.<sup>159</sup>

**Table 1.1** Position of the four main schools (*madhahib*) on *riba al-nasi'a* and *riba al-fadl*

<b>Hanafi</b>	<b>Maliki</b>	<b>Shafi'i</b>	<b>Hanbali</b>
<p>The exchanged counter-values are all measurable or all weighable and belong to the same genus, for example, the sale of wheat for wheat.</p> <p><b>No gain permitted in a hand-to-hand transaction, nor is a deferred transaction permitted, even without gain.</b></p>	<p>The exchanged counter-values are all currencies or all storable foodstuffs for humankind and belong to the same genus, as in the exchange of dinars for dinars or wheat for wheat.</p> <p><b>No gain permissible in a hand-to-hand transaction, nor is a deferred transaction permitted, even without gain.</b></p>	<p>The exchanged counter-values are all currencies or all foodstuffs and belong to the same genus, such as the sale of dates for dates or gold for gold.</p> <p><b>No gain permitted in a hand-to-hand transaction, nor is a deferred transaction permitted, even without gain.</b></p>	<p>The exchanged counter-values are all measurable or all weighable and, furthermore, are foodstuffs, such as the sale of rice for rice, or grain for grain.</p> <p><b>No gain permitted in a hand-to-hand transaction, nor is a deferred transaction permitted, even without gain.</b></p>
<p>The exchanged counter-values are all measurable or all weighable but belong to different genera, such as the sale of gold for silver.</p> <p><b>No deferred transaction permitted, even without gain. Gain permissible in a hand-to-hand transaction.</b></p>	<p>The exchanged counter-values are all currencies or all storable nourishment for humankind, but belong to different genera, for example the exchange of dinars for dirhams or wheat for broad beans.</p> <p><b>No deferred transaction permitted, even without gain. Gain permissible in a hand-to-hand transaction.</b></p>	<p>The exchanged counter-values are all currencies or all foodstuffs, but belong to different genera, such as the sale of gold for silver or dates for wheat.</p> <p><b>No deferred transaction permitted, even without gain. Gain permissible in a hand-to-hand transaction.</b></p>	<p>The exchanged counter-values are of the same genus and all foodstuffs, but neither measurable nor weighable, such as the exchange of watermelons for apples, or all measurable or all weighable, but no foodstuffs, such as the exchange of gold for silver.</p> <p><b>No deferred transaction permitted, even with no gain. Gain permissible in a hand-to-hand transaction.</b></p>

<sup>159</sup> Saleh, op. cit., pp.20–26.



<p>The exchanged counter-values are neither measurable nor weighable, but belong to the same genus, such as the sale of an animal for an animal.</p> <p><b>No deferred transaction permitted, even without gain. Gain permissible in a hand-to-hand transaction.</b></p>	<p>The exchanged counter-values are all foodstuffs that are not governed by the Maliki '<i>illa</i>, whether or not they belong to the same genus, such as the sale of bananas for lettuce.</p> <p><b>No deferred transaction permitted, even with no gain. Gain permissible in a hand-to-hand transaction</b></p>	<p>One of the exchanged counter values is foodstuffs; the other is not, such as the sale of wheat for iron.</p> <p><b>No deferred transaction permitted, even without gain. Gain permissible in a hand-to-hand transaction.</b></p>	<p>The exchanged counter-values belong to different genera and are properties governed by one '<i>illa</i>, i.e., they are all measurable or all weighable or all foodstuffs such as the sale of wheat for barley.</p> <p><b>No deferred transaction permitted, even without gain. Gain permissible in a hand-to-hand transaction.</b></p>
<p>One of the exchanged counter values is measurable, whereas the other is not (whether weighable or not), such as sale of wheat for silver or pomegranates, OR one of the exchanged counter-values is weighable, whereas the other is not (whether measurable or not), such as the sale of gold for wheat or quinces.</p> <p><b>Gain permissible, whether in a hand-to-hand or a deferred transaction.</b></p>	<p>The exchanged counter values are neither edible nor drinkable, but are all either weighable or measurable, belong to the same genus and, furthermore, serve the same purpose, such as the sale of material for material.</p> <p><b>No deferred transaction permitted, even without gain. Gain permissible in a hand-to-hand transaction.</b></p>	<p>The exchanged counter-values are neither foodstuffs nor currencies, whether or not they belong to the same genus, such as the sale of lime for lime or lime for lead.</p> <p><b>Gain permissible, whether in a hand-to-hand or a deferred transaction</b></p>	<p>One of the exchanged counter-values is currency and the other one an article susceptible to <i>riba</i>, i.e., measurable, weighable or foodstuffs.</p> <p><b>Gain permissible, whether in a hand-to-hand or a deferred transaction.</b></p>



<p>The exchanged counter-values are neither measurable nor weighable and, furthermore, belong to different genera, such as the sale of pomegranates for quinces.</p> <p><b>Gain permissible, whether in a hand-to-hand or deferred transaction.</b></p>		<p>One of the exchanged counter-values is currency, the other is not, whether or not foodstuffs; examples are the sale of rice for silver or iron for gold.</p> <p><b>Gain permissible, whether in a hand-to-hand or deferred transaction.</b></p>	<p>The exchanged counter-values belong to different genera and are governed by different <i>'ilal</i>; for example, one is measurable (wheat), and the other is weighable (meat).</p> <p><b>Gain permissible in a hand-to-hand transaction. Conflicting opinions regarding deferment, with a trend towards permission.</b></p>
			<p>The exchanged counter-values are neither measurable nor weighable nor foodstuffs; an example is the sale of a riding animal.</p> <p><b>Gain permissible, whether in a hand-to-hand or deferred transaction.</b></p>

## 1.4 The Islamic Financial System

The above discussion clearly shows that *riba* is prohibited in the Shari'a. If a bank is to conform to the Shari'a, then *riba* is one of the principal elements that must be eliminated from its system, and with it, all exploitation. Lenders are now required to share effort or risk with the entrepreneurs, who are now assured of a positive return according to their level of effort and skill in management. This is the social justice envisaged by Islamic economists.

The Islamic economic system is governed by Islamic commercial law (*fiqh al-mu'amalat*), comprising a set of contracts and instruments, without which trans-

actions are legally void. Below is a description of Islamic contracts, including an assessment of Islamic and conventional banking practices.

#### **1.4.1 Assessment of Islamic and Conventional Banking Practices**

During the nineteenth and twentieth centuries AC, the rise in Islamic revivalism encouraged many ‘ulama’ to reject the interest-based banks and their services.<sup>160</sup> Some well-known individuals such as Muhammad ‘Abduh (d. 1905), the Grand Mufti of Egypt, and his disciple, Muhammad Rashid Rida’ (d. 1935) tried to accommodate some forms of interest.<sup>161</sup> However, Hassan al-Banna (d. 1949), the founder of the Muslim Brotherhood in Egypt, Sayyid Qutb (d. 1966), its ideologue, and Abu al-A’la Mawdudi (d. 1979), the Pakistani scholar who founded Jama‘at-e-Islami, are among the scholars who condemned interest and the banking system based on it.<sup>162</sup> In December 1985 (1406 AH), the Council of the Islamic *Fiqh* Academy (IFI) of OIC supported the restrictive interpretation of the early jurists by condemning all interest-bearing transactions as void. In their third resolution, the Academy invited the governments of all the Muslim countries to encourage and enable the financial institutions to operate in accordance with the principles of the Shari‘a. The aim was to respond to the needs of Muslims so that they would not be forced to live in contradiction between the demands of their faith and the realities of life.<sup>163</sup>

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<sup>160</sup> Saeed, op. cit., p.9. In his view, although many factors appear to have influenced the emergence of Islamic banks in the 1960s and 1970s, the most important could be the following: (1) neo-Revivalist condemnation of interest and *riba*; (2) the oil wealth of the conservative Gulf states; and (3) the adoption of the traditional interpretation of *riba* by the economic policymakers of several Muslim states.

<sup>161</sup> Saleh, op. cit., p.28. In the summary of ‘Abduh and Rida’, Saleh suggests that they would accept the first increase on a termed loan as lawful. However, if, at the date of maturity, it is decided to postpone the date against a further increase, this would be prohibited.

<sup>162</sup> Saeed, op. cit., p.9.

<sup>163</sup> Warde, op. cit., p.57. See also, <http://www.islamibankbd.com/page/oicres.htm#10> (cited 10 February 2007).

Al-Zuhayli also points out that modern Islamic scholars differ over whether banking interest is unlawful. Dr ‘Abd al-Mu’nim al-Nimr published an article in June 1989, containing a religious ruling permitting banking interest. In July and November 1989, Dr Muhammad Sayyid Tantawi (then the Mufti of Egypt) issued several fatwas permitting interest for investment certificates and limited banks. In 1991, he issued a fatwa permitting all banking interest throughout the world.<sup>164</sup> However, in 1992, the federal Shari‘a Court of Pakistan dismissed that fatwa as the “solitary opinion of Shaikh Tantawi of Egypt.”<sup>165</sup> Finally, in 1999, the Shari‘a Appellate Bench of the Supreme Court of Pakistan gave its landmark decision, banning interest in all forms and “by whatever name it may be called.”<sup>166</sup> Al-Zuhayli also concludes that banking interest is the *riba* prohibited in the Qur’an and the Sunna, as well as by the consensus of the Companions of the Prophet (pbuh) and the later nation.<sup>167</sup> Concerning Islamic financial institutions, al-Zuhayli gives further clarification as follows:

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<sup>164</sup> Al-Zuhayli, op. cit., pp.339–340.

<sup>165</sup> Warde, op. cit., p.57. Warde states: “On other occasions, Tantawi launched frontal attacks against Islamic banks, accusing them of hypocrisy and of misleading [language by]using the word Islam in their appellation. In a 1995 speech, he criticized Western-style banks that established ‘Islamic’ subsidiaries to meet the growing demand for such services. He said that there was little difference between Western-style banks that offer fixed interest rates, and Islamic banks in which depositors share the risk of investing in projects, for Islam simply requires financial transactions to be marked by ‘clarity and justice’. Even more provocatively, he argued that ‘banks which set’ fixed interest are closer to Islam because they make clear people’s entitlement.” Warde adds, “Tantawi’s successor as Mufti, Shaikh Nasir Farid Wassel, took the same position, declaring: ‘I will give you a final and decisive fatwa: so long as the banks invest the money in halal, the transaction is halal.’” Shaikh Nasir Farid Wassel, according to Warde, called for an end to the controversy about bank interest, adding “There is no such thing as an Islamic or non-Islamic bank.”

<sup>166</sup> Muhammad Taqi Usmani, *The Text of the Historic Judgement on Riba (Interest) Given by the Supreme Court of Pakistan 23rd December 1999* (Petaling Jaya, Malaysia: The Other Press, 2001), p.1.

<sup>167</sup> Al-Zuhayli, op. cit., pp.348–349.

Thus, since the transactions of Islamic financial institutions are far from the forbidden *riba*, and they provide useful economic tools to meet the economic needs of Muslims, they are permissible. In this regard, Islam does not forbid anyone from making reasonable profit (up to 20% or 33%). While some people doubt that certain types of profits made from Islamic banks may seem familiar to *riba*, we note that as long as the means used to obtain those profits are permissible, the transactions are permissible. Thus, while some may argue that the increase in price for deferment (say, in instalment payments of an item purchased through *murabaha*), we say that the Muslim jurists permitted such transactions to meet the economic needs of Muslims. Such contract are not exploitative, on the contrary, they help the consumer to obtain goods that he would not otherwise be able to consume. Similarly, commission and fees that Islamic financial institutions charge for their services may be thought by some to be forbidden *riba*. However, most of the activities of those institutions take the form of rental (e.g. in maintaining such space, or preparing paperwork for transactions), or agency in exchange for a fee. All such fees and commissions are permissible and should not be confused for the forbidden *riba*.<sup>168</sup>

#### 1.4.2 Islamic Economics: Contracts

Coulson describes a contract in the Shari‘a as a legally recognized undertaking.<sup>169</sup>

The Arabic word *‘aqd* (pl. *‘uqud*) means “tie” or “bond”. *‘Uqud* can be translated as “contracts”, because the term in the Western sense is applied to legal transactions that are concluded with an offer by one party and acceptance by the other. However, in Islamic jurisprudence, an *‘aqd* or contract is applied to a legal undertaking that is very different from “the binding promise” constituting a contract in Western legal systems.<sup>170</sup>

Udovitch stipulates the following four rules applicable to all commercial transactions: (1) consent of the contracting parties; (2) legal competence of the contracting parties; (3) a subject matter; and (4) a consideration. Should evidence be required in later litigation, a fifth rule ought to be added: the presence of qualified wit-

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<sup>168</sup> Ibid., p.342.

<sup>169</sup> Noel J. Coulson, *Commercial Law in the Gulf States* (London: Graham and Trotman, 1984), p.18.

<sup>170</sup> Ibid.

nesses.<sup>171</sup> A contract is not required to include a special formula or to follow a particular format. However, Udovitch points out that the Arabic papyri contain hundreds of examples of sale contracts, tax receipts, etc., all duly witnessed and the names of the witnesses recorded. According to the standards of current practice, these documents were considered to have the status of evidence.<sup>172</sup> Although from the historical point of view, not every business transaction needs to be in writing, for important transactions, a written document must be included as evidence for future reference. Udovitch supports this advice:

The numerous contracts and other business records preserved in the Cairo Geniza bear eloquent testimony to the importance attached to written documents in the commerce of the medieval Islamic world. For purposes of reference, records of business transactions were preserved for long periods and often accompanied the merchants in their travels from India to Tunis. The elaborate care taken of written contracts is exemplified by the fact that, in several instances, copies of the same contract were dispatched by two or three different routes in order to ensure the safe arrival of at least one at the desired destination.<sup>173</sup>

#### 1.4.2.1 Classification of Contracts

Coulson defines the system of '*uqud*' as based on four contracts covering two primary criteria: (1) whether the transfer is of the corpus or the usufruct; and (2) whether it is for the sake of consideration.<sup>174</sup> The types of contract under this system are as follows:

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<sup>171</sup> Abraham L. Udovitch, *Partnership and Profit in Medieval Islam* (Princeton, NJ: Princeton University Press, 1970), p.86.

<sup>172</sup> Ibid. Udovitch states: "A written agreement *per se* does not give rise to any obligation, nor does it constitute competent evidence in the event of litigation. Theoretically, a written document can acquire legal force only through the verification of its contents by oral testimony of qualified witnesses. It is the oral testimony which is the decisive factor in determining the existence and nature of obligation. The existence of documentary evidence constitutes, at best, corroborative evidence only."

<sup>173</sup> Ibid., pp.87-88.

<sup>174</sup> Coulson, op. cit., pp.18-19.



1. *Bay'* or sale: the transfer of the corpus for a consideration (*tamlik 'ain bi 'iwad*);
2. *Hiba* or gift: the transfer of the corpus without a consideration (*tamlik 'ain bila 'iwad*);
3. *Ijara* or hire: the transfer of the usufruct for a consideration (*tamlik manfa'a bi 'iwad*);
4. *'Ariya* or loan: the transfer of the usufruct without a consideration (*tamlik manfa'a bila 'iwad*).<sup>175</sup>

Although there are many types of contract that do not fall into this group, these four, headed by the contract of sale, are the most important according to the legal manuals.<sup>176</sup> Haque also states that the contract of *bay'* forms the core of the Islamic law of obligations.<sup>177</sup>

Bakar classifies contracts under two main headings: unilateral and bilateral. Unilateral contracts consist of transactions that are gratuitous and do not require the consent of the recipient. They include:

1. Gift (*hiba*);
2. Offsetting of a debt (*ibra*);
3. Wills (*wasiyyat*);
4. Endowment (*waqf*);
5. Loan (*qard*).

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<sup>175</sup> Ibid., p.19.

<sup>176</sup> Ibid.

<sup>177</sup> Ziaul Haque, *Landlord and Peasant in Early Islam: A Study of the Legal Doctrine of Muzara'a or Sharecropping* (Islamabad: Islamic Research Institute, 1977), p.313.



Bilateral contracts consist of all remaining transactions, which are subject to stricter rulings and guidelines, requiring the consent of both parties to the contract under one of the six following classifications:

1. Contracts of exchange (*'uqud al-mu'awadat*);
2. Contracts of security (*'uqud al-tawthiqat*);
3. Contracts of partnership (*shirka*);
4. Contracts of safe custody (*wadi'a*);
5. Contracts of the utilization of usufruct (*'uqud al-manfa'a*);
6. Contracts of the carrying out of work (for example, *wakala* and *ja'ala*).

Bakar states that most contracts are those of exchange (*bay'*) and utilization of usufruct (*ijara*). These two contracts cover the main commercial activities and are the basis of other types of contracts.<sup>178</sup>

Below is a more detailed description of the types of contract, following Coulson's classification.

#### SALE (*BAY'*)

*Bay'* means a "transaction", to include both sale and purchase. In the Shari'a, it is used to mean *mubadala* or a simple exchange of commodities, that is, an exchange to which both parties have consented.<sup>179</sup> With reference to sales contracts, Haque states that both senses of the words *bay'* and *mubadala* imply a contract or agreement (*safqa, mubaya'a, mu'ahada*), when, in the original sense, the purchaser slaps the

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<sup>178</sup> Mohd Daud Bakar, "Contracts in Islamic Commercial and Their Application in Modern Islamic Financial Systems". Teaching material used at the Centre for Research and Training, Kuala Lumpur, 2002, p.7.

<sup>179</sup> Haque, op. cit., p.313.

palm of the seller to indicate acceptance (*qabul*) of the offer (*ijab*).<sup>180</sup> Coulson explains that *bay'* (contract of sale) is the unconditional and immediate transfer of the ownership of an existing and determined object of legal value, capable of delivery, for a fixed price.<sup>181</sup> To avoid any speculation, risk or uncertainty, the price may be paid immediately, or deferred until a specific time, or paid in instalments over a fixed period.<sup>182</sup> This is an ideal procedure according to the Shari'a, because it eliminates an unforeseeable profit for one party.

*Bay'* covers not only the exchange of a commodity for money (sale), but also that of a commodity for another commodity (barter), or that of money for money (*sarf*). The last two transactions are similar to barter and currency exchange (*sarf*), but different from an exchange of a commodity for money. Since these transactions are open to *riba*, they are subject to stricter Islamic principles to guarantee their legality and to prevent the influence of *riba al-fadl* and *riba al-nasi'a* respectively.

Coulson explains that sales contracts cover three other types of transactions:

1. Bay'al-wafa.
2. Istisna'
3. Salam

These transactions are governed by different rules from those of the basic *bay'* as follows:

1. The transfer of ownership is unconditional.
2. The sale item exists.

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<sup>180</sup> Ibid.

<sup>181</sup> Coulson, op. cit., p.19.

<sup>182</sup> Ibid., p.20.

3. Delivery is immediate.<sup>183</sup>

## HIRE

*Ijara* means “lease” and “hire”. It is the transfer of usufruct (*manfa‘a*) by corporeal property or personal service for a consideration. The consideration can be rent (*ujra*) for the hire of an object, or wages (*ajr*) for the hire of a person or people.<sup>184</sup>

Corporeal property can be any of the following three forms:

1. Immoveable property, such as land and premises.
2. Merchandise, such as furniture, machinery, etc.
3. Animals.

Concerning the legal aspect of *ijara*, Coulson notes that there is no distinction between immoveable property of land or houses and moveable goods, chattels and animals.<sup>185</sup> However, when hiring people, there is a distinction between a “private employee” or servant (*ajir khass*), who agrees to give his services exclusively to the employer during the period of the contract, and an independent contractor or “public employee” (*ajir mushtarak*), who is hired to perform a specific task or service.<sup>186</sup> According to Coulson, these *ijara* contracts are the basic form, to which the three fundamental principles apply. The *manfa‘a* must be precisely defined; the consideration (rent or wages) must be of fixed value, and the period of hire must be clearly stated.<sup>187</sup> However, when a “hire-type” agreement does not conform to these three principles, it becomes a separate nominate contract and subject to its own individual

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<sup>183</sup> Ibid., p.21.

<sup>184</sup> Ibid., p.22.

<sup>185</sup> Ibid.

<sup>186</sup> Ibid.

<sup>187</sup> Ibid.

rules.<sup>188</sup> These contracts include agricultural tenancies, trading ventures (*mudaraba*) and reward (*ja'ala*).

## GIFT

A transaction is defined as a “gift” (*hiba*) where the gratuity is one of corpus (*'ain*). If the transfer is only of usufruct (*manfa'a*), then it is called *'ariya*, though, strictly speaking, *'ariya* refers to the loan of a particular and identifiable chattel or piece of property. The loan of money or any fungible good is termed *qard*.<sup>189</sup>

## OTHER CONTRACTUAL INSTITUTIONS

Although, strictly speaking, the other institutions do not fit into the four types of contract or the associated exceptions, nevertheless, they complement and reinforce the basic system and are therefore integrated into it.<sup>190</sup> These institutions include partnership, assignment of debt (*hiwala*), guarantee (*kafala*), pledge (*rahn*), deposit (*wadi'a*) and agency (*wakala*).

Despite the differences in the classification of contracts, as shown in the above discussions, each of these classifications consists of different yet interrelated transactions to form a complete system of *mu'amalat*. These differences are tailored to suit the needs of people in a wide range of circumstances, and they also ensure justice in society itself.

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<sup>188</sup> Ibid.

<sup>189</sup> Ibid., pp.24–25.

<sup>190</sup> Ibid.

#### 1.4.2.2 Contracts in the Contemporary Islamic Financial System

Al-Hawary et al. of the World Bank classify contracts of economic activities into transactions and intermediation.<sup>191</sup> Transaction contracts include exchange, trade and the financing of economic activities, whereas intermediation contracts facilitate an efficient and transparent implementation of transaction contracts. The authors state that the combination of these two types of contract offer a set of instruments with varying purposes, maturities and degrees of risk to satisfy diverse groups of economic agents.<sup>192</sup> Intermediation contracts include *mudaraba*, *kafala/aqd-daman*, *ammana*, *takaful*, *wakala* and *ja'ala*. Transaction contracts are divided into three groups: (1) miscellaneous; (2) asset-based securities; and (3) equity participants. The contract of *qard hasana* is classified as miscellaneous, and *musharakah* as equity participation. Asset-based securities are divided into trade financing and collateralized securities. *Murabaha*, *Bay' salam* and *bay' mu'ajjal* are contracts classified as trade financing. Collateralized securities include *ijara* and *istisna'*.

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<sup>191</sup> Dahlia A. el-Hawary, Wafiq Grais, and Zamir Iqbal, "Regulating Islamic Financial Institutions: The Nature of the Regulated". Paper presented at the International Conference on Islamic Banking: Risk Management, Regulation and Supervision, held in Jakarta, 30 September – 2 October 2003, p.7.

<sup>192</sup> Ibid.

# CHAPTER TWO



## 2 Islamic Economics, Financial Intermediaries and Contemporary Issues

### 2.1 An Overview

Islamic banking is a subset of Islamic economics and forms part of *mu'amalat* (relationships between human beings) with particular reference to commercial and trading activities, in which the application of the Shari'a is the basic code of conduct. Islamic banking is a new phenomenon compared with the interest-based financial system, which has dominated the world for centuries. Although there is evidence of a widespread practice similar to Islamic banking among Eastern traders throughout the Middle Ages and even before the birth of Prophet Muhammad (pbuh), the Muslim world gave way to a *riba*-based financial system when the economic system came under the control of Western imperialism. Muslims themselves are also responsible for this situation, having neglected the true teachings of Islam. These teachings need to be applied to all aspects of Muslim life, to the social, economic and political arenas as well as to personal matters such as family affairs and acts of worship.

The existence of Islamic banking is also closely related to the rise and fall of Islamic civilization. As stated by Chapra:

Due to a number of historical circumstances, the Muslim world lost its technological and economic vitality. Hence, a number of Islamic institutions, including the Islamic system of financial intermediation, became displaced by Western institutions. However, the independence of Muslim countries has led to the

revival of Islam and there is a longing to gradually reinstate most of the lost institutions, the Islamic financial system being one of them.<sup>1</sup>

Scharf also asserts:

Contrary to what Westerners often think, interest-free banking should not be considered as merely a concessionary or subsidised financial practised. Viewed in its historic context, Islamic law on interest was above all practical. The economy of the Arabian peninsula in the 7<sup>th</sup> century was that of trading city-states living in a hostile environment. In economic terms, the constraints were illiquidity and scarcity and the results were usury and hoarding. Islamic precepts aimed to control such undesirable social phenomena. If interest rates imposed on long-distance traders were too high, this either discouraged trade or substantially increased the cost of commodities for investors as well as consumers, resulting in a net loss to the community.<sup>2</sup>

According to Zaher and Hassan in the earlier references, commercial or mercantile activities that complied with Islamic principles were classified under the “umbrella” of “interest-free” or Islamic banking.<sup>3</sup> However, the term “Islamic financial system” appeared only in the mid-1980s, when it was realized that the Islamic financial system was not limited to banking but also included financial instruments, financial markets and all types of financial intermediation. Indeed, it complies with an existing system that prohibits interest and speculation, advocates the sharing of risk by all the relevant parties, regards money as potential capital, upholds the sanctity of contracts and promotes engagement in activities complying with the Shari‘a.

Today, the Islamic financial system has come into existence to satisfy the needs of believing Muslims, whose global population constitutes more than 1.2 billion. Akacem and Gilliam explain that this situation has been due to two main

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<sup>1</sup> M. Umer Chapra and Tariqullah Khan, *Regulation and Supervision of Islamic Banks*, (Jeddah, Saudi Arabia: Islamic Research and Training Institute: Islamic Development Bank, 2000), p.3.

<sup>2</sup> Traute Wohlers-Scharf, *Arab and Islamic Banks: New Business Partners for Developing Countries* (Paris: Development Centre of the Organization for Economic Co-operation and Development [OECD], 1983), p.75.

<sup>3</sup> Tarek S. Zaher and M. Kabir Hassan, “A Comparative Literature Survey of Islamic Finance and Banking”, *Financial Markets, Institutions and Instruments*, vol.10, no.4 (2001), p.155.

factors.<sup>4</sup> The first was the oil price shocks of the 1970s, which led to an increase in the per capita income of oil-producing countries. The second was the establishment of an Islamic republic in Iran in 1979, under the Khomeini government, together with further oil price shocks. The result has been the revival of Islam and the Shari'a in its entirety, the increasing awareness of which has encouraged Muslims all over the world to conduct their lives according to the true teachings of Islam, and therefore to seek an alternative to conventional banking, one which is consistent with Islamic teachings. Zaher and Hassan support this view in stating that the main impetus to establish Islamic banks was the desire of Muslims to reorganize their financial activities to comply with the principles of the Shari'a, thus enabling them to conduct financial transactions without engaging in *riba*.<sup>5</sup>

It appears that the enormous expansion of Islamic banking since the 1980s has been reflected in growth opportunities in related industries, such as the Islamic capital market, *takaful*<sup>6</sup> businesses, and Islamic stock broking among others. This has also encouraged the entrance of new players into the industry,<sup>7</sup> product innovation, and the penetration of new markets. Nevertheless, although the current achievement in Islamic banking is very encouraging, it has also attracted criticism.

This chapter discusses the basic principles of Islamic economics and how they are viewed by some Islamic scholars. It examines the need for financial intermediaries to cater for the Muslim population as well as the historical evidence of deposits

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<sup>4</sup> Mohammed Akacem and Lynde Gilliam, "Principles of Islamic Banking: Debt versus Equity Financing", *Middle East Policy*, vol.9, no.1 (2002), p.124.

<sup>5</sup> Zaher and Hassan, op. cit., p.156.

<sup>6</sup> *Takaful* is an Arabic word meaning "guaranteeing each other" and is a form of an Islamic insurance.

<sup>7</sup> To capitalize on the potential market, a number of global financial institutions, including Citibank, Goldman Sachs, BNP-Paris-Bas, and UBS, have established Islamic banking services compatible with the Shari'a in several countries.

and financing activities from pre-Islamic times to the Middle Ages. There is also a brief look at the critiques of Islamic economics.

## **2.2 Concepts of Ownership and the Distribution of Income and Wealth in Islam**

Islamic teachings place a strong emphasis on economic activities. Indeed, the stability of a whole nation is heavily dependent on its economic position. The richest states with a strong economy have power over other countries in the world. This explains why the economy holds a special position in the Islamic social framework.

Islamic economics cannot be isolated from other basic elements of Islam such as *'aqida* (creed), *'ibada* (worship) and *akhlaq* (morality). Islam considers the life of a human being as an indivisible entity. In Islam, individuals need and complement one another in society. Therefore, a human being must be an individual and a communal being at the same time. Islam, as an all-encompassing way of life, provides for every aspect of a person's existence, and seeks an order based on a network that inter-relates with the concepts of God, humanity, humankind's relationship to God, a human being's position and role in the universe, and his/her relationship to his/her fellow human beings.

Since trade and economics play a crucial role in the lives of individuals and society as a whole, Islam has laid down rules covering every aspect of commercial activities. *Fiqh al-mu'amalat* (Islamic commercial law) regulates all trade and economic relationships. It is a comprehensive law that guides and governs all aspects of human conduct in trade-related economics, such as relations between contracting parties, lawful and unlawful means of earning an income, and lawful and unlawful products and services. Since the economic system is subject to modernization and innovation owing to technological advances, modern business and commercial prac-



tices have also been transformed. According to Siddiqi, as far as the economic aspects of a person's life are concerned, the Qur'an does not hold any brief for a feudal, capitalist or socialist structure of society, or for any particular structure, for that matter. It gives clearly defined values for an economic policy that conforms to an Islamic way of life, irrespective of time and place.<sup>8</sup> Accordingly, the scholars (*fuqaha*) today are obliged to take responsibility for resolving specific economic problems within the limits set by the Qur'an and Sunna.

### **2.2.1 What is Economics?**

The *Encyclopaedia Britannica* defines the term "economics" as meaning strictly the art of applying money (or wealth) wisely, and it has commonly come to mean the art of saving money, or spending as little as possible.<sup>9</sup> Economics is also the science of investigating how nations or other larger or smaller communities and their populations obtain food, clothing, shelter and whatever else is considered desirable or necessary for the maintenance of and improvement in the condition of life.

From these definitions, economics is a study of people's behaviour as agents of consumption and production. The system of values that they practise or to which they subscribe will determine their behaviour in the system. Thus, economics is a social rather than a natural science. It is a discipline in which there is always room for change and improvement. In natural science, on the other hand, the laws of nature are fixed and unavoidable; humans have to obey the laws of natural science, which are determined by God Himself.

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<sup>8</sup> Muhammad Nejatullah Siddiqi, *Some Aspects of the Islamic Economy* (Delhi: Markazi Maktaba Islami, 1972), pp.135–137.

<sup>9</sup> William Albert Samuel Hewins, "Economics", in *Encyclopaedia Britannica* (London: Cambridge University Press, 1910–1911), p.899.

### 2.2.2 Basic Principles of Islamic Economics

As has been stated by Scharf, the concept of Islamic economics differs from that of capitalism in its resistance to excessive accumulation of wealth. It also conflicts with socialism in its protection of the right to own property, including the means of production.<sup>10</sup> Chapra supports this concept by stating that since the very foundation of the Islamic system is different from that of capitalism and socialism, which are both earth-bound and not oriented to spiritual values, the super-structure must necessarily be different.<sup>11</sup> He adds that any attempt to show the similarity of Islam to either capitalism or socialism can only demonstrate a lack of understanding of the basic characteristics of the three systems.<sup>12</sup> According to Abdul Mannan, Islamic economics is the study of humankind, not of an isolated individual but a social individual having faith in the Islamic values of life. A Muslim engaged in the production of wealth is, consequently, engaged in a fundamental act of worship to Allah, or *'ibada*.<sup>13</sup>

The spirit of the establishment of the Islamic banking system is to create socio-economic justice.<sup>14</sup> Therefore, Islamic banking is more than banking procedures and

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<sup>10</sup> Scharf, op. cit., p.74.

<sup>11</sup> Muhammad Umer Chapra, *Islam and the Economic Challenge*, Islamic Economics Series 17 (Leicester, UK: The Islamic Foundation 1992), p.6.

<sup>12</sup> Ibid., pp.342–353.

<sup>13</sup> Muhammad Abdul Mannan, *Islamic Economics: Theory and Practice* (Kent, UK: Hodder and Stoughton, 1986), pp.18–19.

<sup>14</sup> According to Kamali "Social justice subsumes economic justice but the two are not identical. Both are concerned with the equitable distribution of wealth in society, which implies that economic justice is, however, an essential component of social justice. Economic justice is possible to achieve without social justice, but not vice versa. Social justice will not, for instance, accept a situation in which political powers and liberties are unjustly distributed, yet this would not be a problem for economic justice. Social justice is thus a broader concept as it refers to the structure and policies of a society, and to its political, legal, economic and social institutions. See, Mohammad Hashim Kamali, *Freedom, Equality and Justice in Islam* (Cambridge, UK: The Islamic Texts Society, 2002), pp.105–106.



mechanisms; its purpose is also to provide fair dealing for both banks and customers. Socio-economic justice implies that the elimination of poverty is a major objective. People must work hard to meet their own needs and those of their dependants. Thus, society must be supportive, making economic opportunities available to individuals so that they can use them as a means of harnessing their creative abilities. It is a basic fact that all human beings want to live better lives, and they are willing to make the effort to improve their condition as long as they believe that there is enough justice in the system to reward them. Indeed, once individuals acquire wealth, they must use it to create more economic activities. This provides a way for individuals to contribute to society in line with social justice. A peaceful and well-organized society can be achieved when the wealth is fairly distributed for the good of all its members.

Before continuing this study in greater depth, it is necessary to discuss the basic principles of Islamic economics as the foundation of an Islamic banking system. The aim is to clarify the basic principles governing Islamic economics, which distinguish it from modern economics. According to the literature on Islamic economics, there are a number of differences between the two systems. The principles of Islamic economics can be summarized as follows.

#### **2.2.2.1 BELIEF IN DIVINE GUIDANCE**

Islam is an Arabic word that connotes submission, surrender and obedience.<sup>15</sup> The foremost belief in Islam is that the whole universe has been created and is controlled

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<sup>15</sup> Shaikh Mahmud Ahmad, *Economics of Islam (A Comparative Study)*, 3<sup>rd</sup> edn (Lahore, Pakistan: Ashraf Press, 1958), p.2. "Another literal meaning of the word 'Islam' is 'Peace' and this signifies that one can achieve real peace of body and of mind only through submission and obedience to Allah"

by the One God.<sup>16</sup> Allah created everything on this earth for human beings to utilize. Human beings, as part of the creation, have been appointed as caliphs or vicegerents on the earth to obey Allah's Command and fulfil certain objectives. This is not restricted to worship in the form of religious rituals, for it also includes obedience in one's social responsibilities towards the community.

#### **2.2.2.2 OWNERSHIP OF PROPERTY**

Ownership means having the authority and power of possession.<sup>17</sup> Human beings acknowledge that Allah has complete possession of this universe and absolute power over it, whereas their own power and authority are limited. Therefore, the ownership of property given to human beings should thus be viewed as a trust (Qur'an 2:29–30). Human beings do not have the right to possess as much as they desire or to obtain material wealth in any way they choose. All resources and the acquisition, ownership and utilization of property are subject to limits fixed by Allah. Therefore, the right to property is not absolute, but is restricted and qualified.

Islam encourages everyone to increase his or her wealth by working hard and using all possible fair means for this purpose. The concept of private ownership is not totally overlooked. Private ownership is regarded as the foundation of the Islamic socio-economic order, serving as the basis of other economic as well as social injunctions. Indeed, every owner of property has the right to use it to earn more money by engaging in commerce, services, mining, construction etc. However, this must be practised according to a certain code of conduct. It is an obligation for each

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<sup>16</sup> Qur'an (20:6): "To Him belongs what is in the heaven and on earth, and all between them, and all beneath the soil."

<sup>17</sup> Seyyed Muhammad Taleqani, *Islam and Ownership*, trans. Ahmad Jabbari and Farhang Rajaee (Lexington, Kentucky, US: Mazda Publishers, 1983), p.88.

Muslim to contribute his/her excess income to those in need by payment of *zakat* as well as by providing voluntary assistance to society.

The system of *zakat* is an Islamic concept of equity whereby, having accumulated a certain amount of wealth and rather than seeking one's own personal pleasure, through greed, in wasteful consumption and other negative activities, one uses the money to help others. In this way, Islam aims to achieve a balance between the right of individual ownership and the safeguarding of the wider interests of society as a whole. In Islam, *zakat* is not an end in itself, but rather a means to an end, namely, to allow the needy and the poor to become self-sufficient by helping them in the initial stages of establishing a business, for example, so as to give them a head start. *Zakat* is there to help those who are in need of it to support them until they can stand on their own feet. Under an Islamic economic system, there would be a balance in the moral and social order by ensuring the equal availability of opportunities and resources, resulting in the development of a peaceful and caring society. The system of *zakat* also aims to protect the self-respect of individuals, who are then able to obtain the means of earning a living from their own efforts, rather than from begging or depending on charity to support them for their entire lives.

From the discussion above, it is clear that the ideal of Islamic economics promises to have a positive impact on economic activities, which are, in turn, an important part of human life. In Islam, the stability of the whole society is believed to be subject to both the material and spiritual well being of humankind. Both aspects are integrated into every act and requirement of human beings. The ideal of Islamic economics stands in opposition to the secular system, under which material dominance is the ultimate objective of human society.

### 2.2.3 Profit Maximization from an Islamic Perspective

Since profit and price are closely inter-related, the discussion begins with the Islamic view of this aspect of economics. In conventional economic theory, a firm is said to be rational if its sole objective is profit maximization. Profit indicates the status, power and size of a business. According to Keown et al., "In microeconomics, profit maximization functions largely as a theoretical goal, with economists using it to prove how firms behave rationally to increase profit."<sup>18</sup> The authors state that the preferred goal of the firm should be the maximization of shareholder wealth. Therefore, by maximizing the price of common stock, all the effects of financial decisions are included. Investors react to poor investment or unacceptable dividend decisions by causing the total value of the firm's stock to fall, and they react to acceptable decisions by pushing up the price of the stock; in the end, price equals value.<sup>19</sup> Although the viewpoint is different, the goal is the same. For the firm to maximize the common stock price, it has to ensure that it has earned the maximum profit. If the firm has made losses, current or potential investors will not invest and, at the same time, the total value of the firm's stock will be pulled down.

Economists have defined a rational firm as one that maximizes profit, whether it is operating in perfect competition or a monopoly. For example, in perfect competition, the firm is assumed to have no influence on the market price of the goods that it sells. Therefore, the firm has to consider the price as given to it. The firm devises an efficient production plan so that it can produce goods as efficiently as possible. This means that the firm is trying to reduce its per unit or average cost,

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<sup>18</sup> Arthur Keown, John D. Martin, William Petty and J.R. David F. Scott, *Financial Management: Principles and Applications*, 10th edn (Upper Saddle River, N.J.: Pearson Prentice Hall, 2005), p.4.

<sup>19</sup> Ibid.

while at the same time obtaining the maximum possible revenue. Another example is a monopoly, in which the price is not stipulated, and the firm determines the price that it wants to charge for its product. It is also able to determine the level of production. Therefore, the firm can manipulate prices by producing less, so that when consumers demand that particular product, it imposes a higher price.

### 2.2.3.1 THE ISLAMIC VIEW OF PROFIT

Muslims are urged to do well in this life, for the time spent on this earth is only a passing phase of a life that extends into the Hereafter. Islam insists that believers should actively take part in the search for almost every material gain, with particular reference to trade and ethical profit.<sup>20</sup> Islam instructs people to be moderate in the pursuit of profit, that is, to behave in the prescribed way<sup>21</sup> and acquire only the lawful amount, not the maximum. If conflict arises between wealth and virtue, one should be content with what is lawful, even if it is less.<sup>22</sup> In the words of Ibn Taymiyyah (d. 728/1328):

God not only ordains the Friday congregation and other communal prayers, He also exacts truthful report and the discharge of trusts. He proscribes such abomi-

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<sup>20</sup> For example, ‘Abdullah Yusuf ‘Ali, *The Holy Quran, Text, Translation and Commentary* (Lahore: Shaikh Muhammad Ashraf Kashmiri Bazar, 1937), p.79, comments on the Qur’anic verse (2:198): “Legitimate trade is allowed, in the interests both of the honest trader, who can thus meet his own expenses, and of the generality of pilgrims, who would otherwise be greatly inconvenienced for the necessities of life. But the profit must be sought as from the ‘bounty of God’. There should be no profiteering, or trade ‘tricks’. Good, honest trade is a form of service to the community, and therefore to God.”

<sup>21</sup> Islam forbids fraudulent practices, trading in impure items such as intoxicants, pig products and animals that are not properly slaughtered; public goods such as water, fire, grass. It insists on correct weights and measures. For example, the Qur’anic verse (17:35) states: “Give full measures when you measure, and weigh with a balance that is accurate: That is the most fitting and the most advantageous in the final determination” (7:35). ‘Ali (ibid., p.537) comments on this verse as follows: “Giving just measure and weight is not only right in itself but is ultimately to the best spiritual and material advantage of the person who gives it.”

<sup>22</sup> The Qur’an says: “Not equal are things that are bad and things that are good, even though the abundance of the bad may dazzle you. So fear God, O you that understand, so that you may prosper” (5:103).



nations as lying and deceit, including the giving of small measure and weight, and fraudulent practices in industry, commerce, religious matters, etc.<sup>23</sup>

Righteous behaviour in economics receives a reward called *baraka*. In Islam, the concept of *baraka* is an important; for it gives people a strong incentive to behave well.<sup>24</sup> There are hidden substantive blessings given to those who conduct themselves decently in every aspect of life, including economics.<sup>25</sup> *Baraka* is an “invisible material”, the level of which varies according to the level of an individual’s behaviour and thus it motivates believers to perform righteous acts to please Allah. The more righteous acts performed, the higher the level of *baraka*. The principle of *baraka* can be best explained as expanding one’s wealth “in the name of Allah”.<sup>26</sup> Therefore, one should not expect a high return from the entrepreneur directly, since the provider of the funds will experience no shrinking but rather an expansion of his/her wealth from Allah. What is unacceptable in Islam is unrighteous conduct in economics, that is, the wrongful possession or disposing of wealth, which deprives its holder of his/her *baraka*. This principle applies not only to the individual but also to organizations and to the community as a whole. The concept implies a positive relationship between the management of the system and prosperity. It is understood that society will flourish if its economic activities conform to the rules of the Shari‘a,

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<sup>23</sup> Al-Shaykh al-Imam Ibn Taymiyyah, *Public Duties in Islam: The Institution of the Hisba*, trans. Mukhtar Holland (Leicester, UK: The Islamic Foundation, 1982), p. 30. Ibn Taymiyyah also cited the following Qur’anic verses: “God Exalted said: ‘Woe to the niggardly who exact full measure from other people, but give short weight and measure themselves’” (83:1); “Give full measure and do not be one of those who measure short weight with the true balance and do not deprive people of their due. Do not go about causing mischief” (26:182); “The Exalted One said: ‘God does not love a sinful traitor’” (4:107); “God does not guide the wiles of the deceitful” (12:52).

<sup>24</sup> According to Khan and Mirakhor, the important factor in the incentive system of Islam is the concept of *baraka*, which serves as a material inducement for the individual to practise proper conduct. See, Mohsin S. Khan and Abbas Mirakhor, “Islam and the Economic System”, *Review of Islamic Economics*, vol.2, no.1 (1992), p.10.

<sup>25</sup> Ibid. See, for example, Qur’an 8:60.

<sup>26</sup> Qur’an 2:261 and 7:96.



whereas its prosperity will disappear if morals decline and its members no longer comply with the rules of the Shari‘a.<sup>27</sup> Therefore, the concept of *baraka* is a strong incentive to obey Allah.

### 2.2.3.2 IBN TAYMIYYAH’S VIEW OF PROFIT MAXIMIZATION

It is important in this study to analyse Ibn Taymiyyah’s view of profit maximization, for he was one of the leading medieval scholars to give special attention to fair pricing, although this principle had existed in Islamic jurisprudence since earlier times.<sup>28</sup> Islahi states: “Ibn Taymiyyah, while elaborating upon its application to particular contexts like hoarding (*ihtikar*) and obligatory sale, etc., generalized the idea to cover wages and profits along with the prices of commodities.”<sup>29</sup>

Ibn Taymiyyah acknowledges the idea of profit and the seller’s right to it, and suggests that the sellers can “earn profit in the commonly accepted manner without destroying their interest and the interest of the consumers.” In analysing Ibn Taymiyyah’s writing, Islahi defines a just profit or the “profit of the equivalent” as “the normal profit which is generally earned in that particular type of trade, without harming others.”<sup>30</sup> Islahi also notes that Ibn Taymiyyah regarded profit as the joint creation of labour and capital. For this reason, the owners of both factors of production were entitled to a share in the profits: “The profit is to be divided according

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<sup>27</sup> Khan and Mirakhor, op. cit., p.10, state that the concept of *baraka* applies not only to individual behaviour but also to the whole community. The authors cite Fazlur Rahman’s comment: “A society prospers if it preserves a keen perception of the Message (acts according to its rules); its prosperity departs if its morality declines (acts against the rules of the Shari‘ah).”

<sup>28</sup> Abdul Azim Islahi, *Economic Concepts of Ibn Taimiyyah* (Leicester, UK: The Islamic Foundation, 1988), pp.80–81. Islahi discusses in detail the concept of “just or fair price” before Ibn Taymiyyah’s era.

<sup>29</sup> Ibid.

<sup>30</sup> Ibid., pp.85–86.

to commonly accepted fashion between the two partners – the one who invested his labour and the other who invested the money.”

Ibn Taymiyyah had a clear understanding of how prices are determined by the forces of supply and demand in a free market, for he said:

Rise and fall in prices is [*sic*] not always due to an injustice (*zulm*) by certain individuals. Sometimes, the reason for it is deficiency in production or decline in import of the goods in demand. Thus if desire for the good increases while its availability decreases, its price rises. On the other hand, if availability of the good increases and desire for it decreases, the price comes down. This scarcity or abundance may not be caused by the action of any individuals; it may be due to a cause not involving any injustice, or sometimes it may have a cause that does involve injustice. It is Almighty God who creates desires in the hearts of people.<sup>31</sup>

Clearly, prices can be influenced by factors beyond the control of the sellers. Nevertheless, sellers who intentionally raise prices are considered to be causing an injustice (*zulm*) to society. Furthermore, Ibn Taymiyyah describes how supply and demand in the market have an impact on the prices of goods:

If people are selling their goods in the commonly accepted manner without any injustice on their part and the price rises in consequence of decrease in the commodity (*qillat al-shay'*) or increase in population (*katrah al-khalq*), then this is due to Allah.<sup>32</sup>

In analysing this statement, Islahi says that Ibn Taymiyyah ascribes price rises to either “a decrease in commodity” or an “increase in population”. A “decrease in commodity” is the cause of a fall in the supply of the goods, whereas an “increase in population” is more likely to cause an increase in demand, so this can be reinterpreted as a rise in demand.<sup>33</sup>

In a free competitive market, Ibn Taymiyyah does not favour price control. He recommends price regulation only in a monopoly and where there is an imperfection

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<sup>31</sup> Ibid., p. 88.

<sup>32</sup> Ibid., p. 90.

<sup>33</sup> Ibid.

in the market.<sup>34</sup> Some imperfections in the market, according to Ibn Taymiyyah, are (1) the practice of intercepting goods; (2) exploitation of situations where people are ignorant of market conditions; and (3) the hoarding of necessities. Ibn Taymiyyah does not support the practice of “interrupting” goods before they have been seen by other customers in the market.<sup>35</sup> He cited that this was forbidden by Prophet Muhammad (pbuh) because of the risk to the seller. Since he does not know the regular price of his goods, they might be purchased for less than their value. Neither does Ibn Taymiyyah endorse an abnormal rate of profit, exploitative of a situation where people are ignorant of market conditions (*mustarsil*). He supports his view with the hadith: “To cheat the easy-going customer constitutes illicit gain (*riba*).” Ibn Taymiyyah adds that this falls into the same category as the interception of goods, or the newcomer’s ignorance of the regular price.<sup>36</sup> A similar form of cheating is the hoarding of necessities.<sup>37</sup> The hoarders will buy food that people need and store it with the intention of creating a scarcity and thus raising the price.

### **2.2.3.3 MODERN MUSLIM SCHOLARS’ VIEW OF PROFIT MAXIMIZATION**

Since the conventional theory and practice of the maximization of profit differs from the Islamic principle, it is useful to examine the views of modern Muslim scholars concerning this aspect of economics. Siddiqi suggests that large corporations should

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<sup>34</sup> As he said: “If people’s wants are satisfied, the sellers are producing in a quantity enough for the public and are dealing in their products at normal prices (*al-thaman al-ma’ruf*), and no price regulation is needed. But if the people’s wants are not satisfied without resorting to just pricing (*al-tas’ir al-’adil*), then the prices must be regulated justly without any excess or harm (*la wakis wa la shatat*) to anybody.” Cited by Islahi, op. cit., p.102.

<sup>35</sup> Ibn Taymiyyah, op. cit., pp.31–32. As he said, “Another improper practice is the intercepting of goods before they reach the market.”

<sup>36</sup> For this very reason, the Prophet (pbuh) forbade the townspeople to sell to the nomads, saying: “Leave people alone and God will see that they provide for one another” (Ibn Taymiyyah, op. cit., pp.31–32).

<sup>37</sup> Ibid. Ibn Taymiyyah states that Muslim in his *Sahih* reports on the authority of Ma’mar ibn ‘Abd Allah that the Prophet (pbuh) said: “Only the misguided hoard.”

replace profit maximization as the norm of business policy with stability, security, continuity, good reputation in the eyes of the community, and so on.<sup>38</sup> He also suggests that Muslim businesses should operate within their limits to maximize profit: “Full compliance with the Islamic idea of social justice” and “take the welfare of others into consideration” have been cited by Siddiqi as limitations.<sup>39</sup> Siddiqi asserts that the basis of entrepreneurial behaviour in Islamic society comprises the objectives of a satisfactory profit, a social service and co-operation. He then defines a “satisfactory” profit as any profit between the upper and lower limits.<sup>40</sup> Mirakhor lists three components of Islamic justice in a Muslim society, one of which is “justice in exchange”.<sup>41</sup> He states that the Shari‘a has provided a network of ethical and moral values that cover, in minute detail, the behaviour of all the participants in the market. It requires that these rules be studied and followed by all the participants before their entrance into the market. The market organized along these lines is intended to eliminate all factors opposed to “justice in exchange” and, instead, to promote “fair” and “just” prices for goods and services.

According to Mirakhor, the Islamic concept of a fair price – unlike the scholastic concept of a “just price”, which lacks an operational definition – refers to a price established as a result of the interaction of economic forces operating in a

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<sup>38</sup> Muhammad Nejatullah Siddiqi, *Economic Enterprise in Islam* (Delhi: Markazi Maktaba Islami, 1972, pp.102–106.

<sup>39</sup> Ibid., p.103.

<sup>40</sup> Ibid., p.107. The upper limit is the highest profit permitted by the circumstances (without violating the legally binding part of the Islamic code of conduct). The lower limit is that level of profit which would afford the producers a reasonable standard of living plus a surplus to average out losses.

<sup>41</sup> Ahmad Mirakhor, “General Characteristics of an Islamic Economic System”, in *Anthology of Islamic Banking* (London: Institute of Islamic Banking and Insurance, 2000), p.25.



market in which all the rules of behaviour specified by the Shari'a are observed by all the participants.<sup>42</sup>

## **2.3 The Nature of Financial Intermediaries**

The Islamic banking system based on the values discussed above should contribute significantly to the achievement of the major socio-economic goals of Islam. This section examines the position of intermediaries in the Islamic financial system and the need for them in the pre-Islamic era, after the birth of Islam and during the medieval period as business increased.

Financial systems are crucial for the efficient allocation of resources in a modern economy. Their structure is determined by the nature of financial intermediation, that is, how intermediation is performed and who intermediates between the suppliers and users of the funds. The acquisition and processing of information about economic entities, the packaging and repackaging of financial claims, and financial contracting are common elements in the activities that differentiate financial intermediation from other economic activities.<sup>43</sup> Gup defines the financial intermediary as an economic unit,<sup>44</sup> whose principal function is to manage the financial assets of other economic units.<sup>45</sup> Gup then explains that without intermediation, financial intermediaries could not exist.<sup>46</sup> However, the main functions of a financial

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<sup>42</sup> Ibid.

<sup>43</sup> Dahlia A. El-Hawary, Wafik Grais and Zamir Iqbal, "Regulating Islamic Financial Institutions: The Nature of the Regulated". Paper presented at the International Conference on Islamic Banking: Risk Management, Regulation and Supervision, held in Jakarta, 30 September – 2 October 2003), p.5.

<sup>44</sup> In economic terminology, the economic unit may be an individual, household or firm. The economic activity may be production or consumption.

<sup>45</sup> Benson E. Gup, *Financial Intermediaries: An Introduction* (Boston, MA: Houghton Mifflin, 1976), p.3.

<sup>46</sup> Ibid., p.4. Intermediation is the investing of funds by businesses and individuals in financial intermediaries.

intermediary cover more than this. As stated by Cobham, traditional analyses of banks have focused on their role and ability as specialized intermediaries. However, the modern theory of economics defines the bank as a mechanism needed by small companies and individuals in the absence of a secondary market.<sup>47</sup>

For complex economies and large populations, financial systems acting as intermediaries are necessary to allocate resources efficiently from the surplus side (household savings) to the deficit side (firm or corporate). The inefficiency and wastefulness of direct finance have rightly been compared to that of bartering.<sup>48</sup> In the modern economy, financial intermediaries remove the inefficiency of mismatched requirements by small depositors and entrepreneurs. At the same time, they contribute to financial development and prosperity by pooling deposits from small deposit holders and making them available as larger funds to be used efficiently by the entrepreneur. Entrepreneurs usually need a longer time to use the funds provided by individual savers, which does not suit the needs of the latter. However, financial intermediaries smooth the procedures of placing savings or investments, and of borrowing and lending. In the words of Siddiqi:

If fund owners have to seek out fund users and fund users have to search for fund owners, the net return to the fund owners would be substantially lower than the gross cost of funds to users. Fund owners will subtract search costs together with any risk premiums due to uncertainty about the fund users' trustworthiness. Lower returns on funds will discourage saving. High cost of funds will discourage investment. The overall consequences for the economy will be a smaller volume of production, fewer jobs, lower incomes and a weaker economy as compared to what is achievable through financial intermediation. Intermediation is rightly regarded to be welfare enhancing.<sup>49</sup>

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<sup>47</sup> David Cobham, *Islamic Banking: Perspectives from the Theory of Financial Intermediation* (St Andrews, UK: University of St Andrews, Dept of Economics, 1992), p.6.

<sup>48</sup> Muhammad Nejatullah Siddiqi, *Islamic Banks: Concept, Precept and Prospects*, <http://www.siddiqi.com/mns/ibcp-if.htm>, 1996, p.4.

<sup>49</sup> Ibid.



Financial intermediaries also act as risk-takers between entrepreneurs and individual savers. Entrepreneurs and individual savers have different preferences for risk taking. Individual or small depositors usually avoid risk, preferring to keep their savings in safer places, whereas entrepreneurs tend to use funds to finance projects considered very risky. These mismatches prove again that financial intermediation plays a crucial role, for intermediaries are better placed than individual savers to acquire information and put their funds with safer and more successful investors, while at the same time making funds available to entrepreneurs. Hence, although financial intermediaries expose themselves to risk, their expertise, derived from their ability to gather information from various sources, enables them to reduce the risk markedly by engaging in proper risk management. As has been noted by Allen and Gale, financial intermediaries not only channel resources from capital surplus agents (generally household) to capital deficit (the corporate sector), but they also enable the inter-temporal smoothing of households' consumption and business expenditure, and therefore allow both firms and households to share the risk.<sup>50</sup>

### **2.3.1 Islamic Financial Intermediation**

Financial intermediation in an Islamic economy is essential in the competitive global economy of the twenty-first century. A fast-growing modern economy is unimaginable in a society without financial intermediaries. The fate of a society that eliminated financial intermediation would resemble that of a society that sought to abolish the use of money.<sup>51</sup>

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<sup>50</sup> Franklin Allen and Douglas Gale, *Comparing Financial Systems* (Cambridge, MA: MIT Press, 2000), pp.3-4.

<sup>51</sup> Siddiqi, op. cit., p.4.

Before Islamic banks were established, Muslim traders, producers and business people had to deal with conventional banking. Since they were managing and expanding businesses, they needed funds; without an alternative, they had to deal with an interest-based system. Looking at the role of financial intermediaries as discussed above, it can be said that without a system in place, the Muslim community will grow weak. The present domination of the interest-based economy will continue to have direct consequences on the financial and monetary systems of Muslim societies. As stated by Siddiqi, financial intermediation is a necessity (*darura*) in the full technical sense of the Shari'a term. He also says that without financial intermediaries, there cannot be a sound and healthy economy. Therefore, it is the duty of Muslim society to create a sound economy so that people's basic needs are fulfilled, and the community can defend itself against "internal deviation" and "external aggression".<sup>52</sup>

### **2.3.2 Historical Evidence**

Over the centuries, Islamic financial intermediation has made a considerable contribution to economic prosperity and development. From the very early years of Islamic history, Muslims recognized a financial system without interest.<sup>53</sup> This section examines the need for financial intermediation and its contribution in pre-Islamic times, after the birth of the Islamic state and during the medieval period.

It has been stated by Wilson that in the Middle East, during the era of the barter system, landlords acted as financiers or moneylenders, providing their tenants with

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<sup>52</sup> See, Muhammad Nejatullah Siddiqi, *Role of the State in the Economy: An Islamic Perspective* (Leicester, UK: The Islamic Foundation, 1996), Chapters 1 and 2.

<sup>53</sup> See, for example, Chapra and Khan, op. cit., p.1; and Murat Cizakca, "Historical Background", in *Encyclopaedia of Islamic Banking and Insurance* (London: Institute of Islamic Banking and Insurance, 1995), p.10.

commodities as credit.<sup>54</sup> Usually, financiers were people who had surplus money, precious metals, or any type of monetary instrument that could be used for transactions. As soon as the barter system was replaced with a monetary system, there was an increasing need for financial institutions in the Middle East, for three reasons.<sup>55</sup> Firstly, there was the security risk as well as the cost of protecting the precious items held by individuals or businesses, payments and receipts not being immediately available. Secondly, moneylenders needed skill and expertise to organize funds effectively. Although landlords had acted as moneylenders, their role was actually different from that of moneylenders. In those days, landlords were more concerned with the technique of managing resources to produce crops, and they were unwilling or unable to enter the new profession.<sup>56</sup> Thirdly, transactions were normally carried out using different types of precious metals, which, as monetary instruments, would require specialist knowledge to assess their quality and value. Moneychangers also had to ensure that they held sufficient assets to meet the financial demand. This required an ability to predict or anticipate the requirements of the market. It would obviously be unprofitable for landlords simply to put aside their assets, and yet there might not be a demand for them. As noted by Wilson, both occupations – those of moneychanger and moneylender – could have been practised by the same group of people, for they required similar financial skills and aptitudes.<sup>57</sup> Since Makka was the trading centre, it provided merchants holding surplus assets with the opportunity to offer moneylending facilities and thus indirectly increased the

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<sup>54</sup> Rodney Wilson, *Banking and Finance in the Arab Middle East* (London: Macmillan, 1983), pp.1–3.

<sup>55</sup> Ibid.

<sup>56</sup> Ibid.

<sup>57</sup> Ibid.

need for moneychanging facilities. Merchants who came from different regions and from other countries brought with them different types of monetary items, which could be changed into local monetary instruments. This situation also increased the need for financial intermediation.

In pre-Islamic Arabia, economic activities were of a mixed nature. Nomadism, pastoralism, agriculture and commerce were the ways of life at that time in the Peninsula, although trade was the main activity of the population.<sup>58</sup> In an active economy, where the volume of economic transactions was high, the need for finance was of the utmost importance. Since there was no banking system or financial intermediation in pre-Islamic Makkan society, two methods of using money, or types of finance, were employed:

1. Partnership (*mudaraba*) was the main feature of business at that time. Normally, the demand for an entrepreneur's services depended upon his/her skill and ability to make profits or avoid losses and on his/her reputation among fellow traders.
2. Lending based upon usury was a common practice at that time among the Arabs and between the Arabs and the Jews, the latter currently being resident in the Arabian Peninsula.<sup>59</sup>

When placing deposits, people entrusted their money and valuables to reputable depositors to minimize certain risks. Prophet Muhammad (pbuh), long before he became a prophet, was acknowledged to be a trustworthy person. It is believed that before he migrated from Makka to Madina, he held certain deposits on behalf of

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<sup>58</sup> Ahmed Abdel-Fattah el-Ashker, *The Islamic Business Enterprise* (London: Croom Helm, 1987), p.9.

<sup>59</sup> Ibid., p.12.

their owners for a while and then assigned his cousin, ‘Ali (ra), to return them on his departure.

After the emergence of the Islamic state in 610 AC, the nomadic way of life of earlier years declined significantly and was replaced with trade, agriculture and crafts.<sup>60</sup> Partnership or business on a profit/loss-sharing basis was the only pre-Islamic method of financing business to survive, though it was different in its scale rather than its principles.<sup>61</sup> A type of deposit for safekeeping, returned in exactly the same amount to the depositors when required, was introduced.<sup>62</sup> It is also reported that al-Zubayr ibn al-Awwam, one of the great Companions of the Prophet (pbuh), was entrusted with the safekeeping of money by the traders during the pilgrimage season. However, he refused to use the money as a deposit, preferring to regard it as a loan. According to his son, ‘Abdallah ibn al-Zubayr, al-Zubayr did so because he was afraid that the money might be lost. Homoud says that the reason for al-Zubayr’s action was to achieve two objectives:

1. “He reserved his right to dispose of the money, considering it a loan not a deposit.
2. It represents a secure guarantee to the owner, because where money remains a deposit without use, it would constitute a loss to the owner; but when the

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<sup>60</sup> Ibid., p.13.

<sup>61</sup> Ibid., pp.16–17. According to El-Ashker, the partnership was expanded to attain a larger number of suppliers of funds as well as entrepreneurs, although the concept of the partnership – the sharing of risk and returns between the partners concerned – remained the same. The capital was divided into small shares and the degree of risk and return was small compared with the earlier system of partnership during the pre-Islamic period. This method of financing also helped investors to invest within their financial capability. El-Ashker asserts that with the expansion of the state and its economic activities, the partnership came to resemble a joint-stock enterprise and there was perhaps an over-the-counter financial market, although there are no data to confirm its size or even its existence.

<sup>62</sup> Sami Homoud, *Islamic Banking: The Adaptation of Banking Practice to Conform with Islamic Law* (London: Arabic Information, 1985), p.19.



deposit becomes a loan, it would be secure as the borrower remains liable for it.”<sup>63</sup>

After al-Zubayr died, there remained a sum of money that had not been collected by the depositors. His son, ‘Abdallah ibn al-Zubayr, refused to divide the inheritance with his brothers, even after he had paid all the debts owed by his father. He made an announcement about the surplus during the pilgrimage season for four consecutive years, after which he divided the remainder of the inheritance amounting to about “thirty-five thousand thousand and two hundred thousand dirhams”, that is, 35,200,000 dirhams.<sup>64</sup>

Money changing was not the only financial activity in Makkah. Transfers were also carried out, the procedures of which were similar to those of modern times. It is reported that

Ibn al-‘Abbas used to take the *warik* (i.e., silver minted into dirhams) in Mecca and write the acknowledgement thereof to al-Kufa,<sup>65</sup> [just as] ‘Abd Allah ibn al-Zubayr used to take dirhams from people in Mecca and then write the acknowledgement thereof to his brother, Mis‘ab ibn al-Zubayr in Iraq, where they used to cash it.<sup>66</sup>

These practices continued throughout the medieval Islamic era from the end of the reign of the fourth caliph, ‘Ali, in 660 AC to 1918 AC, covering the Umayyad,

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<sup>63</sup> Ibid., p.20. Homoud adds that much information can be deduced from the behaviour of a respectable Companion of the Prophet (pbuh). Most importantly (1) this behaviour demonstrates a change in the concept of a deposit from that of a trust to that of a loan, which is the “exceptional or inchoate deposit” developed by modern banking until eventually it became defined in many modern laws; and (2) the amounts deposited were not owned by any particular number of people, although it seems that they belonged to several people, thus indicating the widespread reputation of al-Zubayr as a trustworthy user of this kind of deposit. (An “exception or inchoate deposit” is an idea advocated by some French jurists to explain the difference between a deposit according to the concepts of civil law and a bank deposit, on the assumption that a depository in the former case does not own the deposit but keeps it in custody, whereas a depository in the latter case owns the money deposited.)

<sup>64</sup> Ibid.

<sup>65</sup> Ibid., p.21. (Homoud cites Shams el-‘A’ima al-Sarkhasi, *Mabsut*, Part 14).

<sup>66</sup> Ibid. (Homoud cites Ibn Qudama, Part IV.)



Abbasid and Mamluk dynasties and the Ottoman Empire. Financial activities such as transfers and moneychanging were developed into professional practices by money-changers. Duri indicates that in early Islamic history, a financing system was established by *sarrafs*<sup>67</sup> and *djahbadhs*<sup>68</sup> in Baghdad.<sup>69</sup> This development was a great incentive to commerce and industry, especially during the Abbasid dynasty, when Baghdad became a leading centre of commerce. Markets became an essential feature of its life, whereby each trade had its market, for example, the fruit market, the cloth market, the cotton market, sheep market, etc. The *sarrafs* had their own markets and primarily served the public, whereas the *djahbadhs* served the government and its officials.<sup>70</sup> Chapra and Khan define *sarrafs* as “something akin to Wall Street in New York and Lombard Street in London”, for their operations fulfilled most of the banking needs of commerce, industry and agriculture within the contemporary technological limits.<sup>71</sup> Udovitch also says that although he has encountered bankers and extensive and ramified banking activities in medieval Islamic literary or documentary sources, there has been no mention of banks. Therefore, he prefers to call this system “bankers without banks”.<sup>72</sup>

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<sup>67</sup> *Sarrafa* means moneychanger. According to Chapra and Khan, op. cit., p.2, moneychangers were also called *sayarifah* (sing. *sayraf*).

<sup>68</sup> *Djahbadh* is of Persian origin, perhaps derived from a *gahbadh* in the Sassanid Administration. It is used in the sense of a financial clerk, an expert in matters of coins, skilled money examiner, treasury receiver, government cashier, moneychanger or collector. See, Walter J. Fischel, “Djahbadh”, in *Encyclopedia of Islam*, new edn, vol.2, ed. B.Lewis, C.H. Pellat and J. Schacht (Leiden, The Netherlands: E.J. Brill, 1965), pp.382–383.

<sup>69</sup> A.A. Duri, “Baghdad”, in *Encyclopedia of Islam*, new edn, vol.1, ed. A.R. Gibb, J.H. Kramers, E. Lévi-Provençal and J. Schacht (Leiden, The Netherlands: E.J. Brill, 1960), pp.894–908.

<sup>70</sup> Ibid.

<sup>71</sup> Chapra and Khan, op. cit., p.2.

<sup>72</sup> Abraham L. Udovitch, “Bankers without Banks: Commerce, Banking, and Society in the Islamic World of the Middle Ages”, in Center for Medieval and Renaissance Studies, University of California, Los Angeles, *Dawn of Modern Banking* (New Haven, CT: Yale University Press, 1979), p.257.

The fourth/tenth-century Arabic sources indicate that it was traditional for viziers to have their own *djahbadhs*, with whom they deposited large (legally or illegally acquired) sums of money, for they saw this as the safest method of securing their fortune.<sup>73</sup> However, during the Abbasid Caliphate of al-Muqtadir (295–320 AH/908–32 AC), the *djahbadh* emerged as a banker in the modern sense. This position was in addition to his functions as an administrator of deposits and a remitter of funds from place to place by means of the *sakk*<sup>74</sup> and, in particular, the *suftaja*<sup>75</sup>. The *suftadja* was then a widely used instrument of the credit economy, and was called upon to advance huge sums to the Caliph, the viziers, and other court officials on credit terms, with interest rates and securities.<sup>76</sup>

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<sup>73</sup> Fischel, op. cit., p.382.

<sup>74</sup> According to Nathif J. Adam and Abdulkader Thomas, *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk* (London: Euromoney Books, 2004), p.43, the term *sakk* is “derived from striking one’s seal on a document or tablet representing a contract or conveyance of rights, obligations and or monies”. In a modern concept, *sakk* is a financial security that carries with it specific property rights and obligations including some form of asset ownership.

<sup>75</sup> According to M.Y. Izzi Dien, “Suftadja”, in *Encyclopedia of Islam*, new edn, vol.9, ed. C.E. Bosworth, E. van Donzel, W.P. Heinrichs and G. Lecomte (Leiden, The Netherlands: E.J. Brill, 1997), pp.769–770, “*Suftaja* is a financial term referring to a negotiable instrument in the form of a written bill of credit. *Suftadja* was used in medieval Islam to facilitate the speedy transfer of money over distances or to expedite the exploitation of assignments of taxation in an age when movements of actual cash were hazardous. The *suftadja* thus enabled money to be instantly available in another land through what was in effect a letter of credit. The *modus operandi* was that (A) normally a broker would issue a bill for (B) to collect his money somewhere else from (C), who is an agent for (A). The *suftadja* would only transfer money in order to avoid risk in transport. The debt does not only really exist between the broker (A) and his agent (C). This is due to the fact that (C), the agent, is only an extension of (A), in the same way as are the branches of the bank.” Dien also states: “The Hanafi and Shafii schools consider the practice of *suftadja* to be reprehensible because of debt should be repaid without any form of profit to the owner which results from the avoidance of risk (i.e. involved in an actual cash transfer). The Malikis only allow it on the grounds of necessity, while the Hanbalis permit the practice so long it is done without any material gain, such as commission, accruing to the person repaying the debt. Ibn Taymiyyah and Ibn Qudama permit the practice without reservation, since both the debtor and indebted benefit.”

<sup>76</sup> Fischel, op. cit., p.382.

Adam and Thomas state that documentary evidence for the term *sakk* appears in the early Islamic caliphates and it developed into the Latin-voiced trade terminology of Europe as “check” or “cheque”.<sup>77</sup> The authors add that *sakk* was used to represent financial obligations during the emergence of trade, lending and *mudaraba* activities and was interchangeable with the term *sufiadja* in international trade in the Muslim world.<sup>78</sup> Homoud also states that around 400 AH/1010 AC, Muslim ships and caravans used to travel across various countries and seas for business purposes, yet at least the luxury goods for the whole world were controlled by Alexandria and Baghdad.<sup>79</sup> An efficient and effective payment system was necessary and so, for commercial purposes, the use of cheques became common in the city of Basrah and rules and procedures were established.<sup>80</sup>

Chapra and Khan state that the profit/loss-sharing modes of financing along with deferred trading and interest-free loans (*qard hasan*) were used for raising money to finance production in the medieval Islamic period.<sup>81</sup> These modes of

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<sup>77</sup> Adam and Thomas, op. cit., p.44. They also say that the earliest evidence of the term *sakk* found by the Western researchers is during the first century AH, within a hundred years of the Prophet’s (pbuh) migration to Makka to Madina. They add that a *sakk* or cheque referred to a payment obligation transferred between trustworthy parties on behalf of the primary counterparties to a long-distance trade transaction, often crossing borders and cultures which were hostile to one another in the emerging trade patterns of the later Middle Ages.

<sup>78</sup> Ibid.

<sup>79</sup> Homoud, op. cit., p.21.

<sup>80</sup> Ibid. Homoud cites Ahmad Amin’s narration in Part 1 of his book, *Zuhr al-Islam*, that rules had to be established to regulate transfers. In the middle of the fourth century AH, Sa’id al-Dawla, Amir of Aleppo, visited Baghdad with the intention of exploring the city without being recognized by anyone. He visited the house of Bani Khaqan to listen to the conversation and have a drink. When the time came to leave the place, he asked for the inkpot and wrote on a slip of paper that the sum of one thousand dinars could be collected from a certain moneychanger, and left the paper in the pot. The people of Bani Khaqan presented the paper to the moneychanger, were paid, and were also told that it was Sa’id al-Dawla ibn Hamadan who had written the paper. However, it is true that modern commercial transactions and dealing with cheques can take place only if there exist a surety, strong confidence, trust etc.

<sup>81</sup> Chapra and Khan, op. cit., p.1.

financing, according to Udovitch, helped mobilize the “entire reservoir of monetary resources of the medieval Islamic world” to support agriculture, crafts, manufacturing and long-distance trade of not only the Muslims but also the Jews and Christians. During this period, interest-bearing loans and other overtly usurious practices were not in common use.<sup>82</sup> Other commercial techniques, such as credit arrangements, transfer of debts, and letters of credit were preferred over loans. All these forms of investment and credit were used, since they were allowed by religious doctrine, were held sacred by long practice, and were a socially more congenial and effective means of economic connection.<sup>83</sup> It has been emphasized by Goitein that during an examination of an unusually large number of Geniza documents dealing with credit, a breach of the Jewish, Christian and Islamic laws against interest was found “only once in the record of a judgement”.<sup>84</sup>

The fall of Rome at the end of the fourth century AC, together with the Dark Ages in Europe between the fifth and tenth centuries AC, had a marked impact on business worldwide, and particularly on development and trade activities in the Muslim world. When the West awakened to its new dawn in the twelfth century AC, it also began to develop its own banking system. Again, circumstances influenced the expansion of the banking system in the Muslim countries. In the words of Homoud,

The East submitted, like prisoners of war who had surrendered, to the West, which was awakening to its new dawn. The weak people of the East imagined that the world was previously barren and that civilization had never given birth

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<sup>82</sup> Udovitch, op. cit, p.257.

<sup>83</sup> Ibid., p.258.

<sup>84</sup> Chapra, op. cit., p.1. Chapra quoted that Schatzmiller concluded that financial capital was developed during the early period of Islamic history by numerous owners of monetary funds and precious metals, without the supposed interdiction of *riba* (usury) hampering it in any way.



to neither regulations nor [*sic*] thoughts on the subject, except that which emerged from the womb of the European new era.<sup>85</sup>

However, the practice of *mudaraba* in the westward trade between Egypt and Tunisia, and *musharaka* in the north–south trade between Egypt and Syria as well as between Egypt and Jeddah during the eleventh century has been documented by Goitein.<sup>86</sup> Goitein also found 315 documents in the Geniza archives dealing specifically with trade in the Indian Ocean. Udovitch also highlights evidence that in the thirteenth century AC, similar techniques that had been practised in the Muslim world from the earliest medieval period were adopted in Europe.<sup>87</sup> In addition, in Asia at the end of the fifteenth century AC, shipping in the Indian Ocean was organized according to a *mudaraba* contract. Under this arrangement, each member of the crew was a *mudarib* with a share in the profits. The investors provided the capital and shared the profits according to a pre-determined ratio.<sup>88</sup>

Meanwhile, the function of the *sarrafs* became more significant during the Ottoman Empire, for they were also moneylenders, brokers, and pawnbrokers. Eventually, many *sarrafs* became large financiers with well-recognized international

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<sup>85</sup> Homoud, op. cit., p.24.

<sup>86</sup> Cizakca, op. cit., p.11.

<sup>87</sup> Udovitch, op. cit., p.257. It has also been reported by Chapra and Khan, op. cit., p.3, that the extensive mobilization of savings and their accessibility to business people provided a substantial boost to the growth of output and trade from Morocco and Spain in the West, to India and China in the East, Central Asia in the North, and Africa in the South. Evidence of this exists in historical documents, and also in the discovery of Muslim coins of the seventh to eleventh centuries in parts of Russia, Finland, Sweden, Norway, the British Isles and Iceland, countries which were on the outskirts of the contemporary Muslim world.

<sup>88</sup> It is stated in Meilink-Roelofs, "Trade and Islam in the Malays-Indonesian Archipelago Prior to the Arrival of the Europeans", in *Islam and the Trade of Asia*, ed. D.S. Richards, (Oxford: Cassirer, 1970), pp.151–152: "One thing is clear, in Asia at the end of the 15<sup>th</sup> century; ship-owning was not yet distinct from trade. The ship-owner was not yet in an independent position, and the cost of the transport was not yet entirely his responsibility. The captain did not receive a salary from the people who commissioned his service; instead he shared in the profits. Nor were the members of the crew employed by the owner of the ship paid salaries and they too had a share in the trade. On occasion, the captain could also be the owner of the ship."



connections and they exerted a strong influence on the economy and politics of the Empire. Those practising the profession included Greek Christians, Jews, Armenian Christians and Muslims. With the Ottoman conquest of Constantinople in 857 AH/1453 AC, Italian prominence in finance in that city ended, to be replaced with that of Ottoman non-Muslim subjects, particularly Greeks.<sup>89</sup> During the reign of Mehmed II, the Caliph favoured the Greeks, who played an active role in Ottoman finance and taxation by means of tax-farming and politics.<sup>90</sup> From the mid-tenth/sixteenth century, Jewish bankers (*sarrafs*) and tax farmers challenged the Greek dominance of finance and long-distance trade, for many of them participated in large-scale banking operations, international trade, and investment in tax farms. Later, the role of the Jews declined and it was taken over by the Armenians. It is reported that until the tenth/sixteenth century AC, the *sarrafs* functioned in an atmosphere of expanding trade both inside and outside the Empire and that the stereotypical view of *sarrafs* is that they were, on the whole, non-Muslims.<sup>91</sup> However, Muslims appear to have been operating in all aspects of *sarraf* business, including tax-farming, currency exchange, money lending and international trade. Towards the end of the nineteenth century AC, the Muslim role in *sarraf* business was radically curtailed by the increasing importance of non-Muslim *sarraf* families and the emergence of banks established largely by Europeans and Armenian and Greek *sarrafs*.<sup>92</sup>

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<sup>89</sup> Abdullah Saeed, "Sarraf", in *The Encyclopedia of Islam: Supplement 2004*, ed. P.J. Bearman, T.H. Bianquis, C.E. Bosworth, E. van Donzel and W.P. Heinrichs (Leiden, The Netherlands: Brill, 2004), pp.710–711.

<sup>90</sup> Ibid.

<sup>91</sup> Ibid.

<sup>92</sup> Ibid.

## 2.4 Critiques of Islamic Economics by Modern Scholars

There has never been a blueprint for Islamic economics, even for the period during which the Qur'an was revealed. Thus, Muslim intellectuals and economists face the challenge of constructing a suitable economic system for their own era. One of the main problems confronting them is that the guidance provided in the Qur'an and Sunna for a workable economic system is, admittedly, limited. Although the guidance given in these sources is universal and eternal, its details are more relevant to Arabian society in the early stages of Islamic history.<sup>93</sup> Furthermore, Muslim economists set too easy and too inappropriate an application for present day usage when they try to extract a blueprint for an Islamic economic system from the *fuqaha* writings of the past.<sup>94</sup>

As stated in Chapter 1, only the *fuqaha* are entitled to derive an analogy or certain kinds of consensus from the Qur'an and Sunna. However, Timur Kuran, one of the leading critics of modern Islamic economic literature, emphasizes that all the understanding of the Revelation that depends on human reason, subject to differences of opinion and changing circumstances, presents problems. He adds that there are two basic methodological flaws stemming from unrealistic assumptions, contradictory proposals, and fallacious inferences about the ideal system of economic and distributive justice, which have permeated modern Islamic literature.<sup>95</sup> One is the failure to recognize the anxiety that comes from trying to derive an entire economic

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<sup>93</sup> William R. Roff, Review of *Islamic Economic Alternatives: Critical Perspectives and New Directions* by K.S. Jomo (ed.) in Far Eastern Economic Review (FEER).

<sup>94</sup> Shamim Ahmad Siddiqi, "A Suggested Methodology for the Political Economy of Islam", *Islamic Econ.*, no.13 (2001), pp.3–27.

<sup>95</sup> Timur Kuran, "The Economic System in Contemporary Islamic Thought", in K.S. Jomo, *Islamic Economic Alternatives: Critical Perspectives and New Directions* (Basingstoke, UK: Macmillan, 1992), p.40.

blueprint from the Qur'an and Sunna, owing to the realization that these sources do not offer a comprehensive framework. The other is the failure to recognize that the Islamic past itself demonstrates considerably more flexibility and innovation than is now permitted.<sup>96</sup>

As Siddiqi states, as far as methodological issues are concerned, Islamic economists have generally focused on the two areas where differences in opinion have provided the basis for different schools of thought in economics:<sup>97</sup>

[The first is] related to basic assumptions made by different schools of thought about behavioural norms of individual economic agents such as rationality, utility and profit maximization, self-interest vs. altruism, subjectivity or objectivity of knowledge, etc. [The second deals] with the scope of economics: whether it is or should be positive or normative; is it pure science or social science or an art; can it be separated from other disciplines such as psychology, sociology, politics and anthropology: And it is also related to the issue of how the economy works.<sup>98</sup>

Having covered the ideal concept of Islamic economics together with some historical evidence, this chapter now examines another important aspect of Islamic economics. It evaluates some of the criticism made by modern scholars, particularly Timur Kuran, of the methodology of Islamic economics adopted by Muslim economists, though without ignoring the relevance of an Islamic economic system. The discussion will include the critical part played by behavioural norms in Islamic economics and other issues put forward by Kuran, together with a brief look at the views of Syed Nawab Haider Naqvi and Ziaul Haque concerning the application of *mudaraba* and *musharaka* principles to the Islamic banking system. The critiques of Islamic economics are very important to Islamic economists since they can be used

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<sup>96</sup> Ibid.

<sup>97</sup> Siddiqi, op. cit., p.5.

<sup>98</sup> Ibid.

to clarify problems and help in finding solutions. This section aims to give a clearer picture of the current state of Islamic economics.

### **2.4.1 Behavioural Norms in Islamic Economics**

Among the critics of Islamic economics, some confusion has emerged over the behavioural norms under this system, norms that are assured to be attained by an Islamic education. However, the basic assumptions of neoclassical economics<sup>99</sup> have been criticized by Muslim economists, who believe that the behaviour of Muslim economic agents is different from what is assumed by their neoclassical counterparts. Arif believes that since a Muslim society is significantly different from both capitalist and socialist societies in its moral values, institutional arrangements and objectives in life, the behaviour of its economic agents is, consequently, different.<sup>100</sup> He adds that a clear understanding of economic behaviour is important because Islamic society has to make vital decisions about the alternative uses of resources.<sup>101</sup> Arif states that the microfoundations of Islamic economics are based on the following facts:

1. Economics is a decision science.
2. It is a social science.

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<sup>99</sup> As stated in Muhammad Akram Khan, "Methodology of Islamic Economics", in *Readings in the Concept and Methodology of Islamic Economics*, ed. Aidit Ghazali and Syed Omar, (Petaling Jaya, Selangor, Malaysia: Pelanduk Publications, 1989), p.50, there are three basic assumptions by neoclassical economists of the behaviour of economic agents that have been criticized by Muslim economists: (a) that man is selfish by nature and he behaves naturally; (b) that material progress is a supreme goal; (c) that every person has an inherent tendency to maximize his material welfare, and he also has the knowledge and ability to decide what is good for him.

<sup>100</sup> Muhammad Arif, "Towards Establishing the Microfoundations of Islamic Economics : The Basis of the Basics", in Aidit Ghazali and Syed Omar (eds), *Readings in the Concept and Methodology of Islamic Economics* (Petaling Jaya, Selangor: Pelanduk Publications (M) Sdn. Berhad, 1989), p. 83.

<sup>101</sup> Ibid., p. 87.

3. The individuals who make the decisions are members of the society and their behaviour is determined by the norms, moral values and institutions; and the objectives of the society to which they belong.
4. If the norms, moral values and institutions of one society are different from that of others, it is very likely that the economic decisions made by the members of that society will also be different from those of other societies.<sup>102</sup>

However, in his argument, Kuran has highlighted the flaw in the view of some Muslim economists, who assert that Islamic norms provide a practical solution to modern economic problems.<sup>103</sup> He states:

The primary role of the norms is to make the individual member of Islamic society, *homo islamicus*, just, socially responsible, and altruistic. Unlike the incorrigibly selfish and acquisitive *homo economicus* of neoclassical economics, *homo islamicus* voluntarily foregoes [*sic*] temptations of immediate gain when by doing so he can protect and promote the interests of his fellows.<sup>104</sup>

Kuran adds:

The Islamic norms can be grouped in two categories: production norms, which also include norms involving trade activities, and consumption norms. Regarding the former category, proponents of the Islamic system are careful to point out that Islamic man is free to produce and trade for personal profit. They move on, however, to state that in exercising his freedom, he is required to avoid causing harm to others. He is also obliged to refrain from the earning more than his efforts justify. This means that he must pay “fair” wages, charge “reasonable” prices and be content with “normal” profits. It means, moreover, that he must not engage in speculation and monopolization, or make deals, like insurance contracts, that allegedly involve gambling, uncertainty, and exploitation. In his consumption activities, the Muslim is bound by three sets of norms. First, he must not devote resources to activities, like adultery, or commodities like wine, which are deemed illegitimate. Second, he is required to show moderation in consumption, and therefore, to refrain from “displaying pomp and grandeur”. One side-effect of moderation in consumption, it is argued, is the elimination of the scarcity problem through a lowering of aggregate demand; another is the prevention of demand–pull inflation. Finally, the Muslim must make voluntary donations to less fortunate members of the Islamic community. One Islamic economist notes in this connection that the “ideal is not merely to

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<sup>102</sup> Ibid., p.82.

<sup>103</sup> Kuran, op. cit., pp.11–12.

<sup>104</sup> Ibid., p.10.



give others from surplus....of income over expenses but even to sacrifice and forego [*sic*] one's own share if the need of others is more urgent."<sup>105</sup>

Kuran questions the effectiveness of Islamic norms for two reasons.<sup>106</sup> The first, he says, is that "the implications of these norms are ambiguous in most of the contexts where they are expected to operate." Kuran focuses on wages and price rates in Islamic economics, and argues that after all, the devout Muslim who eagerly wants to follow Islamic norms may be confused in his actions, since he is unclear or unsure about these norms. For example, he might not know what wage is "just" and what profit rate is "normal". Kuran then explains that a devout Muslim who may be unclear about the meaning of "moderation" in consumption would also be unsure about the practical implications of the restriction in Islam about causing harm to others in productive activities. His uncertainty may lead to actions where he may be taken advantage of by other individuals who happened to evaluate and interpret the norms in different ways. Kuran warns these circumstances would provoke threats and reduce people's interest in adhering to the norms. He suggests that modifications could be incorporated by either "self-serving persons or by altruistic individuals trying to strengthen the norms through clarification and systematization". Kuran also stresses:

The ambiguity problem is, of course, very general, arising as it does in the day-to-day interpretation of any social principle. In all existing social systems, well-intentioned people who subscribe to the same principles of justice and efficiency often clash over the application of these principles.<sup>107</sup>

The second reason why Kuran questions Islamic norms is the opposing relationship between the size of a society and the effectiveness of the norms of altruism.

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<sup>105</sup> Ibid.

<sup>106</sup> Ibid., p.12.

<sup>107</sup> Ibid.

Kuran explains that this argument is supported by various studies by sociologists and economists, which show that “in a small community or tribe, where people live in fairly continuous contact and share similar experiences and preferences, individual members tend to display considerable altruism toward the community at large.” Therefore, the members of small communities can trust one another and they tend to rely on one another in their daily lives.<sup>108</sup> However, in wider society, people’s perceptions differ markedly:

A factor reinforcing the arguments that norms of altruism are relatively ineffective ... is that, unlike the member of a small society, a person living in a large one cannot expect to influence the general welfare perceptibly through personal acts of altruism.<sup>109</sup>

The economic and social objectives of a Muslim society differ from those of a non-Muslim society in that Muslims are required to obey the commandments of Allah and to help one another to live according to the teachings of Islam. The underlying ideology is that during their short lives on earth, people are faced with tests and their knowledge of Islam enables them to differentiate between good and bad conduct. Nevertheless, this knowledge does not guarantee that they will behave as required by Islam.

On the other hand, Siddiqi states:

This is not to refute that if all people in an Islamic country change their norms and behavior according to the teachings of Islam, most economic problems of the society would be solved. The point is rather that we cannot and should not base and develop a system which takes this prescribed behavior as given. It would simply be a wrong assumption. But, on the other hand, the critics of Islamic economics should also recognize the fact that a person can behave differently under a different organizational set up and rules of the game.<sup>110</sup>

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<sup>108</sup> Ibid., p.13.

<sup>109</sup> Ibid., p.14.

<sup>110</sup> Siddiqi, op. cit., p.15.

From Siddiqi's proposition, it is clear that it is incorrect to assume that an Islamic economic system can be established and developed simply by accepting that Islamic norms provide a solution to economic problems. Nevertheless, one can assume that individuals might behave differently under a different system and different rules. For example, with an Islamic education and moral influence, individuals in a Muslim society will behave according to their own desire. However, this is not the only way to ensure the behaviour required. As Siddiqi states: "The major parts of the efforts should be centred around devising appropriate rules of the economic game and a structure of material and other social incentives which may help and influence people to act in a desirable way."<sup>111</sup>

Siddiqi points out another important factor overlooked by Timur Kuran and others, which has not been given due emphasis by Islamic economists. The differences in attitude, behaviour and levels of morality among individuals have not been recognized.<sup>112</sup> Although it is true that many individuals in modern Muslim society are untrustworthy, a point that has been criticized in Islamic economics, there do also exist devout Muslims who are honest and trustworthy. It is unfair to deny them their place in society by assuming that everyone behaves in the same manner. Siddiqi suggests that a mechanism should be devised to find the trustworthy individuals and encourage them to come forward to make their contribution towards establishing an economic system based on the precepts of Islam.<sup>113</sup> He also emphasizes that the notion of behavioural norms among the members of a society and the possibility of their acting differently under a different system, prove that the goal of an Islamic

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<sup>111</sup> Ibid., p.16.

<sup>112</sup> Ibid.

<sup>113</sup> Ibid.

economy is viable.<sup>114</sup> Although his suggestion may be seen by some people as too ambitious, it could be realistic. However, establishing the mechanism itself could create further problems.

#### **2.4.2 Other Related Issues**

Timur Kuran states that Islamic economics did not emerge from a drive to correct imbalances, injustice or inequalities in society.<sup>115</sup> He adds that the Indian Muslims who launched Islamic economics in the 1940s were motivated by a desire to defend Islamic civilization against foreign cultural influences.<sup>116</sup> In justification of his statement, Kuran says that according to Sayyid ‘Abd al-A’la Mawdudi, “This new approach to economics was to be a vehicle for establishing, or re-establishing, Islamic authority in a domain where Muslims were falling increasingly under the influence of Western ideas.”<sup>117</sup> Kuran adds that by “replacing Western economic approaches with an Islamic one, Mawdudi hoped to restore the Muslim community’s self-respect and improve its cohesion.” Kuran points out that Islamic economics did not have to meet scientific standards of coherence, precision or realism. It needed only to differentiate itself from the intellectual traditions that it was aiming to displace, since Islamic economics was developed to serve cultural and political ends.<sup>118</sup>

Chapra rebuts Kuran’s statement that “Islamic economics did not emerge from a drive to correct economic imbalances, injustices, or inequalities”, stating that it conflicts with the underlying principle of Islam, which is the establishment of jus-

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<sup>114</sup> Ibid.

<sup>115</sup> Timur Kuran, “Islamic Economics and the Islamic Subeconomy”, *Journal of Economic Perspectives*, vol.9, no.4 (1995), p.156.

<sup>116</sup> Ibid.

<sup>117</sup> Ibid. According to Kuran, Mawdudi was the Pakistani ideologist whose voluminous writings popularized the term “Islamic economics” and set the tone for later contributions to the literature.

<sup>118</sup> Ibid.

tice.<sup>119</sup> Chapra adds that Kuran's contention that the fulfilment of justice is not even a goal is "grossly unfair", since the desire for a just socio-economic order has existed throughout Muslim history, and Islamic economics is only an indication of this emphasis on justice.<sup>120</sup> He also firmly rejects Kuran's statement that Indian Muslims launched Islamic economics and Mawdudi popularized it, setting the tone for later contributions to the literature. In Chapra's view:

One may get this impression if one were to look at only some of the literature available in English; however, if one were to look at the literature available in other languages, particularly Arabic, one would have a different perspective on the launching and popularization of Islamic economics.<sup>121</sup>

Indeed, Hasan al-Banna, Mustafa al-Siba'i, Muhammad Abu Zahra, Sayyid Qutb and M. Baqir al-Sadr are among the twentieth-century Arab scholars named by Chapra as contributing to the development of Islamic economics.<sup>122</sup> Therefore, this area has not been developed or popularized by just one person or nation. Chapra also says that although he cannot identify exactly when the term *al-iqtisad al-islami*, or Islamic economics, originated, it has "its roots deep in the historical writings of Qur'an commentators, jurists, historians and social, political and moral philosophers".

Kuran states that "Islamic economics does not offer a comprehensive framework for a modern economy."<sup>123</sup> Chapra rejects his view: "This statement would be true only if the market system were itself not a comprehensive framework for a

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<sup>119</sup> M. Umer Chapra, "Islamic Economics and the Islamic Subeconomy", *The Journal of Economic Perspectives* (1986–1998), vol.10, no.3 (1996), p.193.

<sup>120</sup> Ibid.

<sup>121</sup> Ibid., p.194.

<sup>122</sup> Ibid.

<sup>123</sup> Kuran, op. cit., p. 170.



modern economy.”<sup>124</sup> According to Chapra, Islam does not wish to eliminate the market system, rather to remove the limitations of conventional economics by putting “a greater emphasis on justice, brotherhood and socioeconomic health and by combining moral, historical, social and political factors emphasized by past Muslim scholars”.<sup>125</sup> Chapra concludes with the following statement:

How far the implementation of reform programs based on Islamic economics will be able to help Muslim countries in realizing development with justice is something only time will tell. It may be hazardous to pass judgment on these programs in their preliminary stage of implementation on the basis of the incomplete and inaccurate data now available. To whatever extent such reforms succeed, they can help improve the operation of the market in terms of both efficiency and equity.<sup>126</sup>

### 2.4.3 Critiques by Other Modern Scholars

The above discussion shows that in the view of scholars of Islamic economics, justice, brotherhood and socio-economics should be incorporated into the system to remove the limitations of modern economics. It also has been mentioned in the Introduction that the application of profit/loss sharing to the Islamic banking system has been seen as the most genuine and promising Islamic contract. However, some scholars argue that this form of contract could be adopted by conventional economics. This section examines the views put forward by Naqvi<sup>127</sup> and Haque<sup>128</sup> in this debate.

Naqvi says that although it is true that the system of profit/loss sharing (*mudaraba*) is lawful according to the Shari’a, it does not necessarily mean that it is

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<sup>124</sup> Chapra, op. cit, p.195.

<sup>125</sup> Ibid.

<sup>126</sup> Ibid., p.196.

<sup>127</sup> Syed Nawab Haider Naqvi, *Ethics and Economics: An Islamic Synthesis* (Leicester, UK: The Islamic Foundation, 1981).

<sup>128</sup> Ziaul Haque, *Islam and Feudalism: The Economics of Riba, Interest and Profit* (Lahore, Pakistan: Vanguard Books, 1985).

the best principle on which an Islamic economy should be based.<sup>129</sup> He also maintains that since *mudaraba* is based on the custom of the pre-Islamic Arabs, not on the Qur'an and Hadith, there is nothing sacred about the system. He suggests that the system should be tested on an economy-wide basis before any possible significant evaluation of it can be made:

It will require all the savers to become risk-takers, something that does not happen when this system is one of the many possibilities open to investors, the option to invest in interest-bearing deposits being not ruled out. The risk-takers may take this form of investment, while the risk-averters will not opt for it. In that case, the preference structure of the investors remains intact while it does not when the system is adopted on an economy-wide basis.<sup>130</sup>

Haque points out:

Some Muslim ruling elites have ingeniously devised an "Islamic" ideology to conserve and justify social and economics relationships based on a decadent *status quo* of feudalism and/or capitalism. Knowing that all Muslims have a great love for the Holy Prophet and Qur'anic Islam, the ruling classes are exploiting the fair name of Islam and have turned Qur'anic concepts into institutions which are in fact the citadels of vested interests.<sup>131</sup>

Haque maintains that *mudaraba* is being "re-interpreted and projected as a sacred religious principle to justify the maximisation of profits under capitalism."<sup>132</sup>

Haque remarks that in the pre-capitalist medieval Muslim society, the two common dominant modes of commercial capital were the business organizations of *mudaraba* and *musharaka*.<sup>133</sup> However, here he is in accord with Naqvi, for he maintains that the commercial capital was the product of the specific economic conditions of the times because of the explicit ban on interest-bearing capital. He also says: "*Mudaraba* existed when there were no modern banking, financial and

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<sup>129</sup> Naqvi, op. cit., p.135.

<sup>130</sup> Ibid., p.136.

<sup>131</sup> Ziaul Haque, "Islamic Perspectives and Class Interests", in K.S. Jomo (ed.), *Islamic Economic Alternatives: Critical Perspectives and New Directions* (Basingstoke, UK: Macmillan, 1992), p.112.

<sup>132</sup> Ibid.

<sup>133</sup> Haque (1985), op. cit., p.180.

corporate institutions; and actually *mudaraba* and money-lenders' capital evolved because there were no other categories of capital where people could invest their wealth."<sup>134</sup>

Based on his knowledge and ideological perspectives, Haque rejects adopting *mudaraba* as an instrument for modern banking and finance for several reasons. In his view, the *mudaraba* contract is very risky and dangerous, for the success of the system depends on the thoroughly trustworthy conduct of the agent.<sup>135</sup> Thus, under a *mudaraba* contract in which the agent is not held liable for the loss of people's investments, this would cause serious difficulty to the investors, for the business demands a high level of responsibility, honesty and integrity.<sup>136</sup> In fact, the Prophet (pbuh) was well known as *al-Amin* (the trustworthy person) for his management of the commenda<sup>137</sup> caravan journeys, for which he used Khadijah's capital, before his call to Prophethood.<sup>138</sup>

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<sup>134</sup> Ibid., p.217.

<sup>135</sup> Ibid., pp.210–215.

<sup>136</sup> "The conception of the agent as an *amin* (a trustworthy party) is the cornerstone upon which the entire structure of equity within the commenda contracts rests." See, Abraham L. Udovitch, *Partnership and Profit in Medieval Islam* (Princeton, NJ: Princeton University Press, 1970), p.240.

<sup>137</sup> The *mudaraba* partnership is also known as *commenda*. See, Nabil A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law; Riba', Gharar and Islamic Banking* (Cambridge, UK: Cambridge University Press, 1986), p.103.

<sup>138</sup> Joni Tamkin Borhan, "The Doctrine and Application of Partnership in Islamic Commercial Law with Special Reference to Malaysian Experiments in Islamic Banking and Finance". Unpublished PhD thesis (Edinburgh University, 1997), pp.74–75. Saleh, op. cit., p.11, states that the Prophet entered more than once into *commenda* agreements, where he acted as the agent-manager.

# CHAPTER THREE

## **3 The Development of Islamic Banking**

### **(Case Study: Malaysia)**

#### **3.1 An Overview**

Chapter 3 discusses the development of Islamic banking around the world and includes a more detailed analysis of Malaysia as a case study. It also looks at the implementation of the profit/loss-sharing modes of financing in Malaysia with the particular focus on Bank Islam Malaysia Berhad (BIMB).<sup>1</sup>

#### **3.2 The Development of Islamic Banking**

Wilson states that the first attempt to introduce an Islamic financial system was in Pakistan in the late 1950s, with the establishment of a local bank in a rural area, though it did not have a lasting impact.<sup>2</sup> This bank was initiated by religious landlords, who deposited funds without interest to be used by small landowners. Borrowers had to pay only a small charge, lower than that of an interest rate, to cover the operating cost. However, it appears that there was difficulty in recruiting bank staff owing to a shortage of funds, and this caused the bank to collapse.<sup>3</sup> According to Ashker, two reasons contributed to its failure to survive: (1) the deposits were too small to cover the credit demands since the money was paid as a single sum with no

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<sup>1</sup> The name Bank Islam Malaysia and its abbreviation BIMB are interchangeable throughout this thesis.

<sup>2</sup> Rodney Wilson, *Banking and Finance in the Arab Middle East* (Basingstoke, UK: Macmillan, 1983), p.75.

<sup>3</sup> Ibid.



further additions; and (2) the bank staff did not have full independent control of the bank's operations, for the depositors were interested in how the money was used.<sup>4</sup>

The second attempt to establish an Islamic bank was made in Mit Ghamr,<sup>5</sup> in the Nile Delta of Egypt, between 1963 and 1967. This model was adapted by its founder, Ahmed al-Najjar, from the concept of the German savings bank.<sup>6</sup> Dr al-Najjar had graduated from a German university. Since he was familiar with the German savings bank model, he decided to adapt the system to the rural environment of Egypt – which was a developing country – when he returned home in the early 1960s.<sup>7</sup> In this model, the bank participated as the joint owner in equity participation and sharing of the profit with the entrepreneur in proportion to the amount of capital invested. However, in this case, the bank held a title deed to the enterprise.<sup>8</sup> Dr al-Najjar managed to establish the bank, helped by a German grant and with the support of the Director of the Egyptian State Intelligence Agency (*al-Mukhabarat*), who introduced him to the Minister of Economics in Egypt.<sup>9</sup>

Scharf states that the mobilization of these savings was very impressive. Previously, capital formation in that area had been impaired, for the majority of the popu-

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<sup>4</sup> Ahmed Abdel-Fattah el-Ashker, *The Islamic Business Enterprise* (London: Croom Helm, 1987), p.32.

<sup>5</sup> Much of the literature on Islamic banks identifies Mit Ghamr as the first Islamic bank in Egypt and in the world. See, for example, Traute Wohlers Scharf, *Arab and Islamic Banks: New Business Partners for Developing Countries* (Paris: Organization for Economic Co-operation and Development [OECD], 1983).

<sup>6</sup> Ibid., p.79.

<sup>7</sup> Samer Soliman, "The Rise and Decline of the Islamic Banking Model in Egypt", in *The Politics of Islamic Finance*, ed. Clement M. Henry and Rodney Wilson (Edinburgh, UK: Edinburgh University Press, 2005), p.267.

<sup>8</sup> Ahmed Abdel-Fattah El-Ashker, "Egypt: An Evaluation of the Major Islamic Banks", in *Islamic Financial Market*, ed. Rodney Wilson (London and New York: Routledge, 1990), p.60.

<sup>9</sup> Soliman, op. cit., p.267.

lation had never had dealings with financial institutions.<sup>10</sup> He adds that as rural and religious people, they were suspicious of Western styles and, furthermore, there were only a few branches of banks within their reach.<sup>11</sup> As a result, the idle capital of their excess income could not be used for productive investment.<sup>12</sup> According to Wilson, the success of the bank was also distinguished by the fact that the problems of rural debt were reduced, for people no longer had to depend on moneylenders, who usually charged a high rate of interest.<sup>13</sup> The success of the bank in attracting depositors was shown in the Mit Ghamr Local Savings Bank Annual Reports 1963–67. The number of depositors increased from 17,560, with deposits worth £E41,000 between 1963 and 1964, to 251,000, with deposits worth £E1.8 million between 1966 and 1967.<sup>14</sup> The bank was also praised by the Ford Foundation in June 1967 for winning the personal support of a large number of farmers and villagers, who regarded the organization as their own.<sup>15</sup>

However, according to Soliman, al-Najjar never made any reference to Islam in the early stages of the bank's operation, lest his project be rejected, for it was also reported that al-Najjar received a German grant of DM780,000 and an Egyptian government grant of £E60,000.<sup>16</sup> Soliman states that al-Najjar had to operate the Mit

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<sup>10</sup> Scharf, op. cit., pp.79–80.

<sup>11</sup> Ibid.

<sup>12</sup> Ibid.

<sup>13</sup> Wilson, op. cit., p.76.

<sup>14</sup> El-Ashker (1990), op. cit., p.61.

<sup>15</sup> Wilson, op. cit., p.76.

<sup>16</sup> Soliman, op. cit., p. 267. Monzer Kahf states that al-Najjar had no political affiliation or aspirations whatsoever. However, his religious background, and possibly his interest in economics as well, were influenced by his maternal uncle, the late Mohammad Abdullah al-‘Arabi, the first Arab economist to write about the principles of Islamic economics. See, Monzer Kahf, “Islamic Banks: The Rise of a New Power Alliance of Wealth and Shari‘a Scholarship”, In *The Politics of Islamic Finance*, ed. Clement M. Henry and Rodney Wilson (Edinburgh, UK: Edinburgh University Press, 2005), p.19.

Ghamr Bank under the guise of a savings banks and incorporate the name of a European country so as to claim a place among the conventional banks based on usury. That was the situation in an era when hostility towards Islamic organizations was at its peak.<sup>17</sup> It was not until the late 1970s, when Islamic banking became legally possible, that al-Najjar declared Mit Ghamr to be the first Islamic bank in history. It is believed that its approval by the Egyptian government was based on socio-economic reasons: to encourage the rural population to put its excess income into savings and to mobilize economic resources.<sup>18</sup>

The experiment of the Mit Ghamr Local Savings Bank came to an end for political reasons in the second half of 1967, when its management was taken over by the National Bank of Egypt and the Central Bank. As a result of the takeover, operational policies were changed: interest-free banking was abandoned and the bank was then operated on an interest basis. Nevertheless, the Mit Ghamr experiment opened the way for the establishment of the Nasser Social Bank in 1971, which was a kind of revival. Furthermore, the closure of the Mit Ghamr led to a decline in the number of depositors, causing a public debate that was finally aired in the Egyptian Assembly. Despite its short life, the Mit Ghamr experiment was studied by many Muslim countries and it was the pioneer for the establishment of the Islamic Development Bank in 1975 and other Islamic banks later.<sup>19</sup>

The Nasser Social Bank was also an interest-free bank, with wider functions than the Mit Ghamr Local Savings Bank and a broad range of equity participation, though foreign exchanges dealings were limited. Its social responsibility was empha-

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<sup>17</sup> Ibid.

<sup>18</sup> Ibid.

<sup>19</sup> El-Ashker (1990), op. cit., p.62.

sized in its Act of Establishment.<sup>20</sup> The Nasser Social Bank was initially supervised and financed by the Ministry of Social Affairs and the Ministry of Finance. According to Scharf, the Bank received 2 per cent of the net profits of public enterprises to finance its services.<sup>21</sup> Kahf notes that its Act of Establishment required public companies to donate 2.5 per cent (a rate selected because of its compatibility with the level of *zakat*), of their profits to the Bank to enable it to create and accumulate its capital and reserves.<sup>22</sup> The Bank itself was charged with the responsibility of receiving this *zakat*.

Kahf rebuts the assertion that either the Mit Ghamr Local Savings Bank or the Nasser Social Bank was the pioneer of the Islamic banking system:

While these writings prepared the Muslim public to see the merits of Islamic banks and later to celebrate their founders as religious heroes, the actual establishment of the Islamic bank unexpectedly came in two areas of the Muslim world far away from each other. Islamic banks were concurrently established in the countryside of Lower Egypt and in metropolitan Kuala Lumpur in Malaysia.<sup>23</sup>

In the mid-1970s, in addition to savings and social welfare institutions, commercial Islamic banks were established. The first Islamic bank to emerge on private initiative was the Dubai Islamic Bank in Dubai in 1975. The governments of the United Arab Emirates and Kuwait had contributed 20 per cent and 10 per cent of the

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<sup>20</sup> Ibid. Soliman, op. cit., p.269, states that although the Nasser Social Bank was created as an interest-free bank, the law relating to its establishment did not base its system on any religious references, but in his opinion, the jargon of Arab socialism. Since Islam is not the only ideology hostile to interest, a version of socialism can also take the same view. The Nasser Social Bank was under the authority of the Ministry of Social Affairs, which does not have any religious competence.

<sup>21</sup> Scharf, op. cit., p. 80.

<sup>22</sup> Kahf, op. cit., p.19.

<sup>23</sup> Ibid. According to Kahf, the existence of Tabung Haji was recognized by Middle Eastern Islamic economists and bankers only in 1981, when it was presented to the Islamic Development Bank during the negotiations to establish the Islamic Bank of Malaysia.

capital respectively.<sup>24</sup> However, the most important stage in the history of Islamic banking was the establishment of the Islamic Development Bank (IDB) in Jeddah, Saudi Arabia in 1975. (The development of Islamic financial institutions and banking can be summarized in seven phases, as shown in Table 3.1).<sup>25</sup>

Although the expansion of Islamic banking in the early years of the twenty-first century is very impressive, its establishment was not an easy task and the procedure varied from one country to another. As pointed out by Haron, Islamic banks were mostly initiated not by governments of particular countries, but by individuals.<sup>26</sup> The Nasser Social Bank is one example of government participation in this project. It is true that a bank is in a strong position if it has the necessary financial support of the government. However, in that situation, the bank also puts itself under government control. Unless the government adheres to an Islamic ideology, the clients might lose their trust in the bank, for they might have doubts about its operation and intentions.<sup>27</sup> Khan also highlights the lack of government support at the initial stage of the establishment of Islamic banking, as described below:

An important difference between attempts at establishing Islamic banking prior to the formal launching of the Islamic banking movement (in the mid seventies) and those that came in the wake of the movement was the presence or absence of government backing. The success of the early spontaneous and decentralized

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<sup>24</sup> Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (Basingstoke, UK: Palgrave Macmillan, 2005), pp.66–71.

<sup>25</sup> The establishment of the IDB was the result of a declaration of intent issued by the finance ministers of 23 member countries of the OIC at a conference held in Jeddah, Saudi Arabia in December 1973. In August 1974, the Article of Agreement to establish the IDB was adopted at a second conference, also held in Jeddah. Following the inaugural meeting of its Board of Governors in Riyadh in July 1975, the IDB went into operation in October of that year.

<sup>26</sup> Sudin Haron, *Sistem Kewangan Dan Perbankan Islam* (Kuala Lumpur: Kuala Lumpur Business School Sdn Bhd, 2005), p.60. Scharf also asserts that the vast majority of Islamic banks and investment companies were established by private initiative. See, Scharf, op. cit., p.86.

<sup>27</sup> Ibid.



experiment (the Egyptian venture) may have made it the ideal prototype, but the lack of government support probably caused its ultimate failure.<sup>28</sup>

According to Saeed, the rapid expansion of Islamic banks at national and international levels occurred after the oil price rises of 1973 and 1974. However, he agrees that the earliest experiments in Islamic banking, for example, the Mit Ghamr Savings Bank and the Nasser Social Bank, cannot be linked to Arab oil wealth.<sup>29</sup> He states:

The oil revenue which began to flow into Saudi Arabia, Kuwait, the United Arab Emirates (UAE), Qatar and Bahrain was an important determinant in the development of Islamic banks, although in the literature one finds an uneasiness on the part of some proponents of Islamic banking in acknowledging this fact.<sup>30</sup>

He adds:

Almost all Islamic banks established in the 1970s in the Middle East were partly, and in some cases totally, funded by oil-linked wealth. The Islamic Development Bank, whose capital is approximately US\$2 billion, has a majority shareholding, that is, more than 60 per cent, by the oil-producing Saudi Arabia, Kuwait, United Arab Emirates (UAE) and Libya. The Dubai Islamic Bank, the Kuwait Finance House, the Bahrain Islamic Bank, the Qatar Islamic Bank, the Faisal Islamic Banks of Bahrain, Niger and Senegal, banks of the Al-Baraka group of Shaykh Saleh Kamil, and Dar al-Mal al-Islami (DMI) of the Saudi Prince Muhammad al-Faisal are totally funded by oil wealth, while the Faisal Islamic Banks of Egypt and of Sudan, and most other Islamic banks in non oil-exporting countries, are partly funded by oil wealth.<sup>31</sup>

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<sup>28</sup> Shahrukh Rafi Khan, *Profit and Loss Sharing: An Islamic Experiment in Finance and Banking* (Karachi, Pakistan: Oxford University Press, 1987), p.58.

<sup>29</sup> Abdullah Saeed, *Islamic Banking and Interest: A Study of Prohibition of Riba and Its Contemporary interpretation* (Leiden, The Netherlands: E.J. Brill, 1996), p.10

<sup>30</sup> Ibid.

<sup>31</sup> Ibid.

**Table 3.1** Islamic financial industry: phases of development

1930s	Critiques of interest from Islamic perspective.	
1950s	Suggestions by Muslim economists and scholars for interest-free banking to replace interest-based banking.	Two-tier model of Islamic bank proposed
1960s	Development of financing based on Islamic principles. Definition of operating mechanism for Islamic financial institutions.	Tabung Haji (Pilgrims Savings Fund) established. Mit Ghamr Local Savings Bank established 1963, collapsed 1967.
1970s	Establishment of Islamic banks and non-banking Islamic institutions. Development of new modes of Islamic finance ( <i>murabaha</i> ). Organization of academic activities. Establishment of academic institutions.	Dubai Islamic Bank established 1975. Islamic Development Bank (IDB) established 1975. First International Islamic Economic Conference held in Mecca 1976. Centre of Islamic Economic Research established in Jeddah. Pakistan resolves to Islamize its entire financial system.
1980s	Continued development of new modes of financing. Interest shown by Western academics and financial experts. Conventional banks, including major international banks offer Islamic products/windows Development of Islamic indices and trust fund.	Islamic banking industries grow rapidly to over \$100 million. Iran and Sudan declare their intention to Islamize their entire financial systems. IMF and World Bank participate in producing papers, articles, research and publications re Islamic banking. Academic institutions around the world begin to teach Islamic finance. Islamic unit trust fund established.
1990s	Development of asset-based Islamic financial products. Development of Islamic products/windows among conventional and major international banks.	Islamic indices established at Dow Jones and Financial Times. Existing Islamic banks expanded and new ones established. Several support institutions established. Accounting standards set for Islamic banks (AAOIFI). Islamic secondary market initiated.

Early 2000s	Continuing development of financial architecture. Greater attention given to risk management, accounting regulation and corporate control. Increased mobilization, based on Islamic principles, of public sector resources.	Islamic Financial Services Board (IFSB) established in Malaysia. First Islamic Rating Agency established in Bahrain.
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*Source:* Based on Ahmad Mohamed Ali, "The Emerging Islamic Financial Architecture: The Way Ahead". Paper presented at the Fifth Harvard University Forum on Islamic Finance, Science Center, Harvard University, Cambridge, MA, 6–7 April 2002.

### 3.3 The Development of Islamic Banking in Malaysia

The establishment of Islamic banking in Malaysia in 1983 was in response to the domestic public demand. However, no one could have predicted that within two decades, Malaysia would be in the forefront of Islamic financial development. During the 1970s, there was a global movement towards the commercialization of the Islamic banking system, spanning countries from Europe and the Middle East to South Asia. Nevertheless, its progress was slow over the following ten years owing to the lack of support and the challenge of competition from the fast-paced conventional banking system. It appears that the introduction of Islamic banking in Malaysia gave the industry the required impetus to attract global interest in this untapped field. Today, in the early years of the twenty-first century, Malaysia, as a multi-racial country,<sup>32</sup> operates a dual banking system, in which both Islamic and conventional banking services are offered to customers, who can then choose whatever suits their needs. The emergence of Islamic banking in Malaysia encouraged an enormous development of the system.<sup>33</sup> Since the Malaysian government envisaged establishing the country as the global hub of Islamic finance,<sup>34</sup> it has implemented the appropriate programmes to expedite its progress in that direction.

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<sup>32</sup> Department of Statistics Malaysia, *2000 Population and Housing Census*: <http://www.statistics.gov.my> (cited 20 February 2006). As revealed in the 2000 Census, Malaysia is a pluralist society. Its estimated population of 21 million comprises 61% Malays and other indigenous people (together, they are described as the Bumiputra community), 30% Chinese, 8% Indians, and 1% others. Malaysia is also a multi-religious society, with 62.8% practising Islam, 19.2% Buddhism, 9.1% Christianity, 6.3% Hinduism, and 2.6% Confucianism/Taoism and other traditional Chinese religions.

<sup>33</sup> Bhupinder Singh in "Banking on Islamic Finance", *Malaysian Business* (16 May 2004), p.31, states that 10% of banking transactions in Malaysia are based on Islamic principles. This is impressive, considering that in 1998, the proportion was only 5%.

<sup>34</sup> Bank Negara Malaysia, *Financial Sector Stability* (Kuala Lumpur: Bank Negara Malaysia, 2001), pp.148–150.

### 3.3.1 The Banking System in Malaysia

The financial system in Malaysia can be divided into financial institutions and the financial market. Financial institutions can be sub-divided into the banking system and non-bank financial intermediaries.<sup>35</sup> Since this study focuses on Islamic banking, the discussion of the general banking system in Malaysia will be brief.

The main component of the financial system is the banking system. It comprises the Central Bank of Malaysia (Bank Negara Malaysia or BNM)<sup>36</sup>, the banking institutions, and other financial institutions, namely, discount houses and the representative offices of foreign banks and offshore banks in the International Offshore Financial Centre in Labuan (Labuan IOFC). The banking institutions comprise commercial banks, which include Islamic banks, finance companies and merchant banks. To complete the entire system, the banking system encompasses the money and foreign exchange brokers, both of which are supervised by Bank Negara Malaysia, since they complement the operations of the primary banking institutions.

Bank Negara Malaysia is the sole currency-issuing authority in the country, and commercial banks are the only institutions allowed to operate current accounts. The banking institutions are supervised and regulated by BNM in accordance with the Banking and Financial Institutions Act (BAFIA) 1989. BNM, as the central bank, is at the top of the banking pyramid and is invested with necessary powers as laid down in the Central Bank of Malaysia Act 1958.<sup>37</sup> The commercial and merchant banks were regulated by the provisions of the Banking Act 1973 and the finance

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<sup>35</sup> Bank Negara Malaysia, *The Central Bank and the Financial System in Malaysia: A Decade of Change* (Kuala Lumpur: Bank Negara Malaysia, 1999), pp.66–99.

<sup>36</sup> The name Bank Negara Malaysia and its abbreviation BNM are interchangeable throughout this thesis.

<sup>37</sup> Bank Negara Malaysia (1999), op. cit., pp.243–253.



companies by the Finance Companies Act 1969, while other financial brokers were covered by guidelines issued by BNM. However, the comprehensive codification of BAFIA 1989 brought all financial institutions under one supervisory and regulatory authority.<sup>38</sup>

Islamic banks are not affected by BAFIA 1989. Although they are under the authority of BNM like other licensed banks, the Islamic banks are also governed by the provisions of the Islamic Banking Act 1983. The IBA was passed as a separate law to exist side by side with the law covering conventional banking.

### **3.3.2 Historical Development of Islamic Banking in Malaysia**

Before and during the early years of independence (1957) in Malaysia, Muslims – particularly the Malays – traditionally lived in the rural areas.<sup>39</sup> Since life was hard at that time, it was impossible for them to think beyond daily survival. Although there was a conventional banking system, it was concentrated in the cities, where the intense economic activity was dominated by the Chinese.<sup>40</sup> The Malays depended on

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<sup>38</sup> Ibid.

<sup>39</sup> The Malays were mainly farmers and fishermen in the rural areas, while in the towns and cities, the Chinese dominated the commercial sector. Most of the Indians – largely Tamil – were labourers on the rubber estates. Firdaus Abdullah, “Affirmative Action Policy in Malaysia: To Restructure Society, to Eradicate Poverty”, [http://www.ices.ik/publications/est/articles\\_jul97/Est-Abdullah](http://www.ices.ik/publications/est/articles_jul97/Est-Abdullah) (cited 20 January 2006). Hirschman concludes that the “racial division” among the multi-ethnic population of Malaysia was mostly a product of colonial practices: Charles Hirschman, “The Making of Race in Colonial Malaya: Political Economy and Racial Ideology”, *Sociology Forum*, vol.1, no.2 (1986), pp.330–361.

<sup>40</sup> Banking in Malaysia can be traced back to 1859, when the first commercial bank in Malaysia, the Chartered Mercantile Bank of India, London and China, was established. Although the first domestic bank was incorporated in 1913, a comprehensive financial sector emerged only after the establishment of the Central Bank of Malaysia in 1959. See, Janice C.Y. How, Melina Abdul Karim, and Peter Verhoeven, “Islamic Financing and Bank Risks: The Case of Malaysia”, *Thunderbird International Business Review*, vol.47, no.1 (2005), p.76.

pawnshops as the main informal type of institution to finance their needs.<sup>41</sup> Nevertheless, according to Borhan, Muslims in Malaysia have developed their own transactions out of prudence and to avoid *riba*-based transactions.<sup>42</sup> One of these customary transactions is *jual janji* (conditional sale), which was prevalent among the Malays in the pre-colonial period, and has survived until now.<sup>43</sup>

In Malaysia, Islamic banking was officially established in 1983, the road to this destination having been paved since 1963 by the establishment of the Pilgrims Savings Corporation, currently known as the Pilgrimage Fund Board (Lembaga Tabung Haji).<sup>44</sup> At that time, its initial purpose was to mobilize the small-scale savings of Malay smallholders according to Islamic principles and thus both to benefit the Malay economy and to facilitate the performance of the Hajj.<sup>45</sup> Its success in both respects led to the widening of its functions, which included the administration and

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<sup>41</sup> Abdul Ghafar Ismail and Nor Zakiah Ahmad, "Pawnshops as Instruments of Microenterprise Credit in Malaysia", *International Journal of Social Economics*, vol.24, no.11 (1997), pp.1343–1352. They also state that pawnshops had been very important in earlier years, especially for the low-income groups (<RM500) and the less-educated (secondary level) groups, whose credit risk excluded them from the formal financial markets. According to F.J.A. Bouman and R. Houtman in "Pawn broking as an Instrument of Rural Banking in the Third World", *Economic Development and Cultural Change*, vol.37, no.1 (October 1988), pp.69–89, rural economies in the developing countries still rely on this informal financial intermediation.

<sup>42</sup> Joni Tamkin Borhan, "The Doctrine and Application of Partnership in Islamic Commercial Law with Special Reference to Malaysian Experiments in Islamic Banking and Finance". Unpublished PhD thesis (Edinburgh University, 1997), p.149.

<sup>43</sup> Ibid. The origin of *jual janji* is the transaction known as *bay' bi al-wafa'*, which is a sale with an option to repurchase. Under this system, a landowner could sell his land to obtain a credit facility at an agreed price. The agreement contained a condition specifying that within a certain period, the seller would have the right to repurchase the land at the same price, although meanwhile, the buyer had the right of occupation and usufruct. If, after the period stated had expired, the seller had failed to repurchase the land, its ownership would be finally transferred to the buyer.

<sup>44</sup> *Latarbelakang Tabung Haji*, [www.tabunghaji.gov.my](http://www.tabunghaji.gov.my) (cited 10 January 2007). The Pilgrims Management and Fund Board (PMBF) or Lembaga Urusan dan Tabung Haji changed its name to Pilgrims Fund Board on 28 August 1997, when the new Pilgrims Fund Board Act (1995) was implemented.

<sup>45</sup> William R. Roff, "Patterns of Islamization in Malaysia, 1890s – 1990s: Exemplars, Institutions, and Vectors", *Journal of Islamic Studies*, vol.9, no.2 (1998), pp.210–212.

organization of Hajj activities for Malaysians according to the Lembaga Urusan dan Tabung Haji (Pilgrims Management and Fund Board) Act 1969.<sup>46</sup>

Following the establishment of Tabung Haji, there was continual pressure during the 1970s from certain individuals, groups and agencies to help establish an Islamic bank.<sup>47</sup> This awakening coincided with the rise in the number of Muslim intellectuals.<sup>48</sup> Emphasis was placed on important aspects of Islamic economics, similar to those of other countries that had adopted Islamic banking.<sup>49</sup> During the Bumiputera Economic Congress in 1980, a resolution was passed, urging the Malaysian government to allow Lembaga Urusan dan Tabung Haji (LUTH) to establish an Islamic bank. Similar resolutions were passed in the same year at various seminars held at state level. In March 1981, at the National Seminar on the Concept of Development in Islam, organized by the Universiti Kebangsaan Malaysia (National University of Malaysia), yet another resolution was passed. It urged the government to pass special legislation immediately as the first step towards establishing Islamic banks and financial institutions based on Islamic principles.<sup>50</sup> At the seminar, it was

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<sup>46</sup> [www.tabung haji.gov.my](http://www.tabung haji.gov.my).

<sup>47</sup> As a non-banking financial institution, Tabung Haji can offer only limited services. Before the establishment of Bank Islam, Tabung Haji also had to deal with conventional banks for its safekeeping and other banking services.

<sup>48</sup> For further details, see Roff, op. cit., pp.218–222.

<sup>49</sup> Mohamed Ariff, “Islamic Banking: A Southeast Asian Perspective”, in *Islamic Banking in Southeast Asia*, ed. Mohamed Ariff (Singapore: Institute of Southeast Asian Studies, 1988), pp.194–212. He states that in the 1980s, secular forces were quite strong in Malaysia, for non-Muslims, who constituted 45% of the population, did not subscribe to the Islamic ideology. However, later in the 1980s, there were visible signs of growing conformity to Islamic codes in Malaysia. Muslim scholars showed renewed interest in Islamic teachings and Muslim social scientists, in particular, were looking for Islamic solutions to current problems.

<sup>50</sup> Bank Islam (M) Berhad, *Annual Report*, 1984, pp.22–24. See also, Zakariya Man, “Islamic Banking: The Malaysian Experience”, in *Islamic Banking in Southeast Asia*, ed. Mohamed Ariff, op. cit., pp.67–102. Borhan, op. cit., pp.151–152, states that the implementation of this resolution was begun in 1981 under Dr Mahathir, the former Prime Minister of Malaysia. Dr

also agreed that LUTH should be responsible for initiating the project. The Muslim Welfare Organization of Malaysia (PERKIM), LUTH and the Development Bank of Malaysia Berhad made independent efforts to study the various aspects of Islamic banking and its implementation in Malaysia.

Therefore, on 30 July 1981, the Malaysian government formed the National Steering Committee of Islamic Banks, comprising twenty members headed by Raja Tan Sri Mohar.<sup>51</sup> The Committee was then co-ordinated at national level with government acceptance of LUTH's proposal to establish an Islamic bank. The National Steering Committee, consisting of three technical committees for the Religious, Legal and Banking Operations, were supplied with reference material, information, and a document – "Model Islamic Bank" – prepared by the International Association of Islamic Banks.<sup>52</sup> The operation of the Faisal Islamic Bank of Sudan and the Faisal Islamic Bank of Egypt was studied by the committees and used as a reference for the establishment of the first Islamic bank in Malaysia.<sup>53</sup>

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Mahathir invited prominent international Islamic scholars to Malaysia and accepted their recommendations for the Islamization of the country's administration by establishing Islamic institutions such as banks and universities. At the same time, the then Prime Minister announced the establishment of an Islamic Research Group and a special enforcement group, whose task would be to conduct research into all aspects of an Islamic economic system as well as assisting the government's development projects by ensuring that they conformed to Islamic principles. According to Tan Sri Nor Mohamed Yakcop (in 2007 the Deputy Finance Minister of Malaysia), Dr Mahathir was, without doubt, the primary force in the implementation of Islamic Banking in Malaysia: "To put his decision in context, Islamic banking at that time [1983] was considered exotic. Most OIC governments were wary of Islamic banking and didn't want to take the plunge. But Dr. Mahathir took the risk and the rest is history." See, Jagdev Singh Sidhu, Malaysian Islamic Banking, *New Straits Times*, 29 October 2001.

<sup>51</sup> Ibid.

<sup>52</sup> Ibid.

<sup>53</sup> Man, op. cit., p.70. See also, Haron, op. cit., pp.74–75.



The following are the three major principles outlined by the National Steering Committee on 5 July 1982, on which the operation of the first Islamic bank was to be based:<sup>54</sup>

1. **The prohibition of *riba* and the sharing of profit and loss.** Profit/loss-sharing is the basis of all economic activity covering money, wealth and labour in Islam. This concept should replace interest as an important mechanism in the present banking system.
2. **The management of Islamic transactions (*mu'amalat*).** The success of Islamic banks is largely dependent on the management's understanding and implementation of the Islamic principles of transactions. Therefore, Islamic banks must ensure that their activities do not conflict with the Shari'a.
3. **The avoidance of activities contradictory to the interests of the Muslim Umma.** Any activity that is not in keeping with the interests of the Umma is equivalent to the misuse and abuse of the wealth entrusted to humankind by God.

The National Steering Committee also proposed the following recommendations concerning the legal framework and control:

1. An Islamic bank that operates according to the principles of the Shari'a should be established.
2. The bank should be incorporated as a limited company under the Companies Act (1965).
3. An Islamic Banking Act should be legislated for and some consequential amendments should be made to other existing related Acts.

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<sup>54</sup> Man, op. cit., p.71; Haron, op. cit., p.74.



4. Bank Negara Malaysia should administer the Islamic Banking Act (1983).
5. The bank should set up a Religious Supervisory Council to ensure that the operations of the bank comply with Shari'a principles.<sup>55</sup>

It could be said that the Muslims in Malaysia have had to wait more than twenty years for the government to introduce Islamic banking. Its decision was influenced by not only the increase in the number of Muslim intellectuals in the country, but also the growing prominence of Islam in Malaysian politics, particularly since the 1980s.<sup>56</sup> The Malay political party UMNO, the main component of the Barisan Nasional,<sup>57</sup> the ruling coalition, was motivated to implement Islamic principles to stay in power. This was largely due to the Islamic challenge from Parti Islam Se-Malaysia (PAS).<sup>58</sup> PAS has openly supported the Islamization of the country's economy and the establishment of an Islamic state.<sup>59</sup> It is also said that the

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<sup>55</sup> Nik Norzrul Thani, Mohamed Ridza Mohamed Abdullah and Megat Hizaini Hassan, *Law and Practice of Islamic Banking and Finance* (Kuala Lumpur: Sweet and Maxwell Asia, 2003), pp.16–17.

<sup>56</sup> Ariff, op. cit., p.197.

<sup>57</sup> Barisan Nasional consists of three parties: UMNO (Malays), MCA (Chinese) and MIC (Indians).

<sup>58</sup> Ariff, op. cit., p.197.

<sup>59</sup> On the other hand, UMNO has favoured a selective and gradual Islamization by first incorporating Islamic principles into the government. For example, in 1986, the Islamic Values Guide has stressed important values, such as trust, responsibility, sincerity, dedication, moderation, diligence, purity (incorruptibility), discipline, co-operation, integrity and gratitude. It shows that if these values were inculcated, then the country could have an effective, strong, just and progressive administration. According to Haneef, planned Islamic reforms in Malaysia began in 1981, when Dr Mahathir Mohammad, came to power. He states: "Unlike its predecessors, and relating to demands of the time, the Mahathir administration decided to utilize Islam as a positive ingredient in the development of nation and its peoples, especially that of Malays. The role of Islam, at the state level, went beyond ceremonial purposes." See, Mohamed Aslam Haneef, "The Development and Impact of Islamic Economic Institutions: The Malaysian Experience" in *Islam in Southeast Asia: Political, Social and Strategic Challenges for the 21<sup>st</sup> Century*, ed. K.S. Nathan and Mohammad Hashim Kamali (Singapore: Institute of Southeast Asian Studies, 2005), pp.82–99.

establishment of an Islamic bank and the International Islamic University<sup>60</sup> was a government strategy to steal the thunder from PAS.<sup>61</sup> Although the Islamic resurgence in Malaysia is said to be the consequence of ethnic-based policy-making,<sup>62</sup> individuals and organizations were, in turn, influenced by the global Islamic resurgence during the 1970s. Ariff concludes that the political climate was just right for the emergence of an Islamic bank in Malaysia.<sup>63</sup> He also comments as follows:

In addition to providing conventional banking services in a *halal* manner through *riba*-free financial transactions, the BIMB has been contributing to the economic development of the Muslim community in particular and that of the country in general. Its main contribution has been in the form of mobilizing savings that would have been otherwise kept idle and undertaking investments that would not otherwise have taken place. There are many Muslims in the country who would not place their money in deposits with conventional banks as it would involve interest payments or would not accept interest payments at all even if their savings are deposited in conventional banks. Although it is hard to ascertain the magnitude of the amount involved, it appears that a sizeable proportion of savings in the rural areas have been kept out of the system because of lack of *halal* outlets.<sup>64</sup>

However, Muzaffar writes that although the Islamic bank might abolish interest, yet, given the capitalist structure of the economy, it will, like other commercial banks, continue to mobilize the savings of the general public for investment.<sup>65</sup> In the author's opinion, the profit generated by the banks will almost always benefit those in the middle and upper echelons of society.<sup>66</sup> As a result, the abolition of interest in

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<sup>60</sup> In the early 1980s, a number of Islamic institutions came into existence – or were reorganized or reactivated – in education, health, industry and commerce. Examples of these are the Islamic pawnshops (*al-rahnu*), Baitulmal, and the Islamic Economic Development Foundation of Malaysia (YPEIM).

<sup>61</sup> Ariff, op. cit., p.200.

<sup>62</sup> Haneef, op. cit., p.85.

<sup>63</sup> Ariff, op. cit., p.200.

<sup>64</sup> Ibid.

<sup>65</sup> Chandra Muzaffar, *Islamic Resurgence in Malaysia* (Petaling Jaya, Malaysia: Fajar Bakti, 1987), p.82.

<sup>66</sup> Ibid.

a capitalist economy without other fundamental changes can lead only to greater injustice and inequalities.<sup>67</sup>

In the development of Islamic banking, the Malaysian government adopted an approach that acknowledged the right of Muslims to have a banking system conforming to their faith. The government also accepted that Malaysia's financial networks, both conventional and Islamic, must serve the needs of the twenty-first century. Without government support, the establishment of an Islamic banking system in Malaysia would not have been possible. The lengthy period required for the system to be operational was due to the high expectations of the general Muslim public. Every aspect of the first Islamic bank, Bank Islam Malaysia Berhad (BIMB), had to be carefully examined and developed before implementation. Since it was carrying the name of Islam, any failure on its part would not have been acceptable, for it would have reverberated throughout the whole system.<sup>68</sup> When discussing BIMB's profit for the first and second year of its operation, Ariff comments:

Not all the Muslim depositors are motivated by Islamic considerations, as there seem to be many who would stay with the BIMB only if profits declared by it are competitive with the rate of interest offered by conventional banks. It is extremely important that the BIMB makes adequate profits not only to give fair dividends to its shareholders and a reasonable rate of return to the depositors, but also to prove that Islamic banks are commercially viable and that they can be an efficient alternative to conventional banks.<sup>69</sup>

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<sup>67</sup> Ibid.

<sup>68</sup> Man, op. cit., p.68. Man also mentions: "A failure would imply not just the failure of the BIMB *per se*, but to Muslims, it would be a failure of the Islamic system in general, which would hardly be acceptable to them.

<sup>69</sup> Ariff, op. cit., p.201.

### **3.3.3 Early Functioning of the Islamic Banking System in Malaysia**

Bank Islam Malaysia Berhad (BIMB) began its operations with an authorized capital of RM500 million, the initial paid-up capital being RM80 million. Its shareholders were as follows:<sup>70</sup>

1. Government of Malaysia (Ministry of Finance): RM30 million;
2. Tabung Haji: RM10 million;
3. Muslim Welfare Organization of Malaysia (PERKIM): RM5 million;
4. State Religious Council: RM20 million;
5. State Religious Agencies: RM3 million;
6. Federal Agencies: RM12 million.

On 1 March 1983, BIMB was incorporated as a limited company under the Companies Act 1965. In the Memorandum of Association of the BIMB preamble, it is stated: "All business of the company will be transacted in accordance with Islamic principles, rules and practices."<sup>71</sup> The Government Investment Act was passed at the same time to allow the Malaysian government to offer Government Investment Issues (GII) based on Islamic principles. The introduction of GII enabled the Islamic bank to meet its liquidity requirements as well as acting as an instrument to absorb idle funds in the short term.

In accordance with the Islamic Banking Act (IBA) (1983), BIMB conducts banking business similar to that of other commercial banks, although applying Shari'a principles under the supervision of the Shari'a Advisory Council. Like conventional banks in Malaysia, on the prudential side, BIMB must abide by certain

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<sup>70</sup> Bank Islam (M) Berhad (1984), op. cit., pp.22–24.

<sup>71</sup> [www.bankislam.com.my](http://www.bankislam.com.my) accessed on 20 February 2007.

rules, such as the minimum risk-weighted capital ratio and the maintenance of a statutory reserve account with Bank Negara Malaysia (BNM). The only difference lies in the liquidity requirement, whereby the Islamic bank observes a two-tier liquid asset ratio. The first liquid asset ratio relates to its eligible liabilities, excluding those of the investment accounts, which are covered by the second liquid asset ratio.<sup>72</sup> Initially, the Bank provided deposit-taking products, such as current and savings deposits, based on the concept of *wadiah* (guaranteed custody), and investment deposits, based on the concept of *mudharabah* (profit-sharing). The Bank provides financing facilities, such as working capital financing under *murabahah* (cost-plus), house financing under *bai' bithaman ajil* (deferred payment sale), leasing under *ijarah* (leasing) and project financing under *musyarakah* (profit/loss-sharing).<sup>73</sup>

The Malaysian government decided to give BIMB a “running-in” period of ten years to enable it to focus fully on the development of Islamic banking before another Islamic bank was established.<sup>74</sup> This ample period allowed BIMB to create as many products as possible so as to provide Malaysians, particularly Muslims, with adequate Islamic banking facilities and services. Among the long-term objectives of BNM is the development of a comprehensive and vibrant Islamic banking system operating alongside its conventional counterpart.

However, the BIMB could not meet all the needs of the population, for its operations were constrained by the small number of branches and limited resources. Furthermore, a single Islamic bank does not constitute a banking system, which would require numerous dynamic and proactive participants, a wide range of pro-

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<sup>72</sup> Bank Negara Malaysia (1999), op. cit., p.243.

<sup>73</sup> Bank Islam (M) Berhad (1984), op. cit., pp.22–24.

<sup>74</sup> Bank Negara Malaysia (1999), op. cit., p.244.



ducts and innovative instruments, and an active Islamic money market.<sup>75</sup> To attain these objectives, the Interest-Free Banking Scheme (*Skim Perbankan Tanpa Faedah*)<sup>76</sup> was launched as a pilot project in March 1993. The project allowed three conventional banks to offer Islamic banking products and services, using their existing infrastructure, including staff and branches. In July 1993, following specific guidelines,<sup>77</sup> the BNM expanded the scheme to the commercial banks, finance companies and merchant banks. In 1994, after careful consideration, an Islamic money market was established to link the institutions with the instruments, and thus complete a comprehensive Islamic banking system in Malaysia. The financial disclosure (GP8) was introduced in 1996 to ensure the transparency of Islamic banking operations, followed by the establishment of fully-fledged Islamic banking branches (instead of Islamic banking “windows” offered by the conventional banks) and the National Shari’a Advisory Council (NSAC).

The Malaysian government’s gradual approach to Islamic banking has been in marked contrast to the revolutionary attitude taken by Iran, Pakistan and Sudan. Malaysia, with its multi-racial population and a particular historical background, has

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<sup>75</sup> Ibid., pp.244–245.

<sup>76</sup> The term “Interest-Free Banking Scheme” has been replaced with “Islamic Banking Scheme” (IBS) or *Skim Perbankan Islam* (SPI), for it did not indicate the Islamic basis of the banks’ operations.

<sup>77</sup> Bank Negara Malaysia (1999), op. cit., p.245: Although the scheme was run on a voluntary basis, the participants (conventional banks) had to abide by the requirements of the scheme, such as establishing an Islamic Banking Unit (IBU) to be headed by a senior Muslim banker, creating an Islamic Banking Fund (IBF) with a minimum allocation of RM1 million, opening separate current/clearing accounts for Islamic banking operations with BNM, registering as Indirect Members under the wholesale payments system, SPEEDS (now RENTAS) and observing a separate cheque clearing system for Islamic banking. The bank is also required to maintain a separate general ledger for its Islamic banking operations to ensure that the bank does not co-mingle the funds freely without proper internal controls. The bank is also encouraged to appoint at least one Shari’a consultant to advise on the day-to-day operations of its Islamic banking divisions.

adopted a “dual banking” system to avoid offending any of its citizens. This system has been accepted by both Muslims and non-Muslims. Non-Muslims do not appear to object to it, provided that no one is forced to patronize the Islamic banks or the IBS banks’ counters.<sup>78</sup> The introduction of Islamic banking alongside conventional banking in capitalist economies, where an interest-based system persists, is one approach to the successful Islamization of the economy.<sup>79</sup> This approach is based on the premise that under existing political, social and technical constraints, Islamization should be gradual so as to avoid any sudden changes that might cause serious upset in the economy.<sup>80</sup> It is hoped that over time, the Islamic banking model will allow interest-based banking to be phased out without any adverse effects on the economy.<sup>81</sup> Instead of legislation prohibiting interest, an alternative system, such as

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<sup>78</sup> Haneef, *op. cit.*, p.89. Tan Sri Nor Mohamed Yakcop says: “Bank Islam was an immediate success when introduced. Many Muslims were just waiting and wanting to benefit from a modern financial system and not get involved in interest, which was *haram*. The commercial banks did not object because they knew the intention was good. They were supportive and did not see a threat from Islamic banking because there was only one bank.” See, Sidhu, *op. cit.*

<sup>79</sup> Man, *op. cit.*, p.67.

<sup>80</sup> Ibid. According to Tarek S. Zaher and M. Kabir Hassan, “A Comparative Literature Survey of Islamic Finance and Banking”, in *Financial Markets, Institutions and Instruments*, vol.10, no.4 (2000), pp.170–172, “In Iran, the tight regulations put in place to conduct the Islamic financial model have caused it to fail, since the drastic action taken by the government to eliminate *riba* has led to a worsening of its informal relationship with external financial communities....The Malaysian Islamic model incorporated Islamic banking into the financial system and harmonized it with the Western practice because an Islamic system should be recognized as a tool for effective financial practices.”

<sup>81</sup> Man, *op. cit.*, p.67. However, Tan Sri Nor Mohamed Yakcop, who was at Bank Negara and participated in establishing BIMB in 1983, says: “I chose a new model by creating a dual system. Here we would have a parallel system that would be equally sophisticated and comprehensive, and have equally good infrastructure to function side by side with the conventional system.” (Sidhu, *op. cit.*) It is also been cited by Borhan (*op. cit.*, pp.197–198) that Dr Halim Ismail, the first Managing Director of BIMB, said that he did not believe in universal Islamization; rather, he upheld the system of co-existence, which he believed to be more suitable to multi-racial Malaysia. Borhan (*ibid.*, p.197) also quoted from Datuk Mustapha Mohammad, the former Deputy Finance Minister, who stressed that the conventional banking system was not going to be abolished or replaced totally with the Islamic financial system .

Islamic banking, should be introduced to compete freely with the interest-based system. Thus, ideally, the interest-based system becomes redundant as a result of customer preference rather than legal prohibition.<sup>82</sup>

### **3.3.4 Supervision and Regulation**

In Malaysia, Islamic banks have to abide by two different sets of rules: those of the Shari'a and those of positive law.<sup>83</sup> However, this does not mean that there is a specific set of Shari'a rules to regulate and control the operations of Islamic banks. On the other hand, positive law is the legal framework implemented by the government of the country where the Islamic banks are established and it is normally described as Western law. In the Muslim world, it has been used as a basis or guidelines as a result of historical factors, since most of these countries were colonized by Western powers. In the case of Malaysia, since the country was colonized by Britain, its government adopted mainly English law.

In Malaysia, all Islamic banks are regulated by the BNM under a separate legal framework, the Islamic Bank Act (IBA) 1983. The rules of the Banking and Financial Institutions Act (BAFIA) 1989, by which other financial institutions are governed, cannot be imposed on Islamic banks because some of its clauses are inapplicable.<sup>84</sup> It is clearly stated in Section 2 of the IBA that Islamic banking means "banking business whose aims and operations do not include any element that is not approved by the religion of Islam."<sup>85</sup> Therefore, Islamic banks must conform to the

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<sup>82</sup> Muhammad Akram Khan, [www.renaissance.com.pk/janvipo2y2.html](http://www.renaissance.com.pk/janvipo2y2.html) (accessed 7 April 2006).

<sup>83</sup> Haron, op. cit., p.243.

<sup>84</sup> Thani et al., op. cit., p.77.

<sup>85</sup> Legal Research Board (ed.), *Islamic Banking Act 1983 (Act 276) – as at 5<sup>th</sup> January 2005* (Kuala Lumpur: International Law Book Services, 2005), p.6.

Shari'a, which is why the IBA provides a separate set of rules to govern their operations.

The IBA was modelled on the Banking Act 1973 with some modifications and amendments.<sup>86</sup> Companies, whether Islamic or non-Islamic, cannot conduct banking business in Malaysia until they have been granted the necessary licence by the Minister of Finance on the advice of BNM.<sup>87</sup> However, there are certain additional requirements, as stated in Section 3(5) of the IBA, which provides that an Islamic banking licence will not be granted to an applicant unless the Minister is satisfied that

1. the aims and operations of the banking business which it is desired to carry out will not include any element that is not approved by the religion of Islam; and
2. there is, in the Articles of Association of the bank concerned, provision for the establishment of a Shari'a advisory body to guide the bank on the operation of its banking business, so that it does not include any element that is not approved by the religion of Islam.

It is also stated in Section 3(5)(b) of the IBA that it is mandatory for an Islamic bank to establish a Shari'a advisory body to supervise its operations.<sup>88</sup> This requirement is to ensure that the internal affairs and operations of the Islamic bank run smoothly, without the risk of proposed activities conflicting with the Shari'a. Therefore, to remove any discrepancies and deal with questions concerning existing products, development of new products, investments, etc. in Islamic banking, BNM

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<sup>86</sup> Ibid., p.5.

<sup>87</sup> Ibid., p.7.

<sup>88</sup> Ibid., p.8.

established the National Shari'a Advisory Council (NSAC) or the Majlis Penasihat Syariah Kebangsaan on 1 May 1997.<sup>89</sup> The primary objectives of the NSAC are:

1. to act as the sole authoritative body to advise the BNM on Islamic banking and *takaful* operations;
2. to co-ordinate Shari'a issues concerning Islamic banking and finance, including *takaful*; and
3. to analyse and evaluate Shari'a aspects of new products/schemes submitted by the banking institutions and *takaful* companies.<sup>90</sup>

In Section 13A(1) of the IBA 1983, it is clearly stated that an Islamic bank may seek the advice of the Shari'a Advisory Council on Shari'a matters, and that the Islamic bank shall comply with its advice. Hence, the Minister in charge can, under Section 11(1)(a), on the recommendation of the BNM, revoke any licence issued if any Islamic bank is pursuing aims or performing operations that include any element not approved by the religion of Islam.<sup>91</sup>

The above discussion shows that there are independent authorities with the powers to supervise the Islamic banks and ensure their adherence to the principles of the Shari'a. Meanwhile, the BAFIA defines the conventional commercial banks as persons who conduct banking business. Section 2 of the BAFIA states: "Banking business means the business of receiving deposits on current accounts, deposit

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<sup>89</sup> Bank Negara Malaysia (1999), op. cit., p.251. IBS (Islamic Banking Scheme) banks are required to appoint at least a Shari'a consultant to assist the banks on any Shari'a operational questions, as stipulated in the IBS guidelines. BNM has also allowed institutions in the banking group (commercial banks, finance companies, merchant banks, discount houses) to maintain a Shari'a consultant to minimize duplication of resources. Although this arrangement has its advantages, BNM has also noted that there some differences in opinion among these consultants on similar questions, a situation that could impede the formation of a sound and healthy Islamic banking system.

<sup>90</sup> [www.bnm.gov.my](http://www.bnm.gov.my). See also, Bank Negara Malaysia (1999), op. cit., p.251.

<sup>91</sup> IBA, op. cit., p.10.



accounts, savings accounts or other similar accounts, paying or collecting cheques drawn by or paid in by customers and the provision of finance.”<sup>92</sup> However, this business is restricted by Section 32 of the BAFIA, which states that no licensed institutions (including commercial banks) shall engage in wholesale or retail trade, including import and export – whether on their own account or on a commission basis, and whether alone or with others – except in connection with the realization of security given to or held by it for the purpose of conducting its licensed business.<sup>93</sup>

A similar provision to Section 32 of the BAFIA is not included in the Islamic Banking Act. BIMB’s Memorandum of Association contains a stipulation in Clause 4,<sup>94</sup> giving BIMB wide powers to conduct trading and commercial activities. Clause 4(15) explicitly states that BIMB may conduct the business of buyers, sellers, importers, exporters, manufacturers of, and dealers in motorcars, cabs, omnibuses, bicycles, sidecars, vans, trucks, lorries and other vehicles.<sup>95</sup>

Therefore, while engaging in banking, BIMB can also conduct other types of business. The reason for this difference from conventional banking is that Islamic banking is based on the principle of loss sharing. If the Islamic banks in Malaysia were required to adhere to Section 32 of the BAFIA, which clearly prohibits trade and business transactions within the banks, they would be prevented from making a profit by venturing into these areas.

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<sup>92</sup> Thani et al., op. cit., p.81.

<sup>93</sup> Ibid.

<sup>94</sup> [www.bankislam.com.my](http://www.bankislam.com.my). Clause 4 provides that “nothing in this Memorandum shall empower the company to conduct any business or do anything that includes any element not approved by the religion of Islam.”

<sup>95</sup> Thani et al., op. cit., p.81.

Having been established under the Companies Act 1965, all Islamic banks in Malaysia must comply with its regulations as well as with those of the Islamic Banking Act 1983.<sup>96</sup> Under the Companies Act 1965, Islamic banks, like other companies, must adhere to certain rules governing, for example, the appointment of directors and auditors, and notice of handling meetings. Should there be any conflict or inconsistency between the IBA and the Companies Act, then the IBA will overrule the Companies Act. Section 55 of the IBA clearly states:

An Islamic bank which is incorporated under the Companies Act 1965 shall be subject to the provisions of that Act as well as to the provisions of this Act, save that where there is any conflict or inconsistency between the provisions of that Act and the provisions of this Act, the provisions of this Act shall prevail.<sup>97</sup>

Nevertheless, the most important element, with direct consequences for Islamic banking in Malaysia, is the legal system itself. Malaysia has a dual system of civil and Shari'a courts. Although Islamic banks are Islamic organizations, their business transactions are under the control of the civil court. The Shari'a court has jurisdiction only over those professing the religion of Islam and regarding matters covered by it, such as marriage, divorce, guardianship, gifts, etc. However, the Shari'a court does not have jurisdiction over cases relating to Islamic banking, for that is constituted under federal law.<sup>98</sup> At present, these cases are dealt with by the civil court. If there is a conflict between an Islamic bank and its customer, the case will be heard in the civil court, not the Shari'a court. Although there have been some cases in which the validity of certain documents has been challenged in the civil court, yet none of these

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<sup>96</sup> IBA, op. cit., p.5.

<sup>97</sup> IBA, op. cit., p.36.

<sup>98</sup> Thani et al., op. cit., p.93 state that banking, money lending, pawnbrokers, control of credit, bills of exchange, cheques, promissory notes and similar instruments are covered by the Federal Constitution.

challenges has been successful.<sup>99</sup> Therefore, the provisions of the Shari'a covering Islamic banking in Malaysia have been put forward as a critical question to be addressed.

Among the objectives of the Financial Sector Master Plan on Islamic banking *takaful*<sup>100</sup> are that the industry will be based on a comprehensive and conducive Shari'a and regulatory framework with the support of a Shari'a commercial court dedicated to addressing legal questions in the judicial system. Shari'a governance was markedly enhanced when the role and functions of the NSAC at BNM were enlarged following the amendment in 2003 of the Central Bank of Malaysia Act 1958. Another important step was that the Malaysian judiciary and the Regional Centre for Arbitration Kuala Lumpur would begin to use the NSAC as the reference point when dealing with disputes over Shari'a matters concerning Islamic banking and finance.<sup>101</sup>

The government has also announced the implementation of tax legislation that will accord Islamic banks tax neutrality,<sup>102</sup> in the hope of creating a fairer system of tax liability for the Islamic banking industry.<sup>103</sup> Before the amendments, Islamic banks had to pay both *zakat* and income tax on their income.<sup>104</sup> However, *zakat* is not deductible as either an allowable expense according to the Income Tax Act or against

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<sup>99</sup> Ibid., p.92.

<sup>100</sup> Bank Negara Malaysia (2001), op. cit., p.150.

<sup>101</sup> Bank Negara Malaysia, *Annual Report* (Kuala Lumpur: Bank Negara Malaysia, 2004), p.164.

<sup>102</sup> Ibid., p.159.

<sup>103</sup> According to the tax neutrality framework, the Inland Revenue Board (IRB) will exempt from additional stamp duty and tax those additional instruments and transactions executed to fulfil Shari'a requirements.

<sup>104</sup> For private individuals in Malaysia, *zakat* based on annual income is allowed to be deducted for the computation of income tax on 100 per cent of aggregate income.

tax liability.<sup>105</sup> Therefore, certain parts of the revenue of Islamic banks were taxed twice. Under the new amendments, *zakat* on business income paid to respective Islamic religious authorities is allowed as a deduction for the computation of income tax not exceeding 2.5 per cent of aggregate income.<sup>106</sup> Although this is a small reduction compared with the previous level, yet this development is encouraging and it is another sign of the government's gradual approach.

### 3.3.5 Achievements of the Islamic Banking System in Malaysia

The Islamic banking system has made steady progress since the establishment of the first Islamic bank in 1983. The government hopes that its development will continue in parallel with conventional banking so as to achieve 20 per cent of total banking assets by 2010.<sup>107</sup> Table 3.2 compares the Islamic banking assets with those of conventional banking between 1994 and 2005.<sup>108</sup>

**Table 3.2** Islamic banks vs conventional banks (RM billion)

Year	Total banking assets	Islamic banking assets	Islamic assets/total assets (%)	Islamic deposits	Islamic financing
1994	326.00	4.89	1.50	2.26	1.74
1995	413.33	6.20	1.50	4.66	3.49
1996	533.16	10.13	1.90	7.26	6.00
1997	703.94	17.88	2.54	9.90	10.75
1998	628.49	21.18	3.37	15.17	10.50
1999	664.34	36.14	5.44	24.80	13.75
2000	680.32	47.01	6.91	35.92	20.81
2001	721.14	59.35	8.23	47.11	28.32
2002	762.26	68.07	8.93	53.18	36.72
2003	847.42	82.20	9.70	60.21	48.66
2004	900.95	94.60	10.50	72.90	57.88
2005	989.38	111.80	11.30	83.90	67.36

Source: Bank Negara Malaysia, *Annual Report* (various issues 1994–2005)

<sup>105</sup> Thani et al., op. cit., p.96.

<sup>106</sup> Bank Negara Malaysia (2004), op. cit., p.164.

<sup>107</sup> Further reading in Bank Negara Malaysia (2001), op. cit., pp.146–164.

<sup>108</sup> These data were gathered from 1994, since the IBS began operating in 1993.

In 2005, the total assets of Islamic banking amounted to only 11.3 per cent of the total assets of the whole banking system, whereas the total assets of conventional banking amounted to RM877.58 billion. This situation indicates that there is still an untapped market to be exploited and also raises the question of whether Islamic banking can achieve the target of 20 per cent of the total assets of the whole banking system by 2010.

Until October 2006, there were ten Islamic banks, eight commercial banks, four merchant banks, five discount houses and five development financial institutions offering Islamic banking services. These financial institutions are listed in Table 3.3.

**Table 3.3** Financial institutions offering Islamic banking services  
(as at 19 October 2006)

<b>Islamic Banks</b>	Al Rajhi Banking and Investment Corporation (Malaysia) Berhad Affin Islamic Bank Berhad AmIslamic Bank Berhad Bank Islam Malaysia Berhad Bank Muamalat Malaysia Berhad CIMB Islamic Bank Berhad EONCAP Islamic Bank Berhad Hong Leong Islamic Bank Berhad RHB Islamic Bank Berhad Kuwait Finance House (Malaysia) Berhad
<b>Islamic Banking Scheme (Commercial Banks)</b>	Alliance Bank Berhad Citibank Berhad HSBC Bank (M) Berhad Malayan Banking Berhad OCBC Bank (Malaysia) Berhad Public Bank Berhad Southern Bank Berhad Standard Chartered Bank Berhad
<b>Merchant Banks</b>	Affin Merchant Bank Berhad Alliance Merchant Bank Berhad AmMerchant Bank Berhad Commerce International Merchant Bankers (CIMB) Berhad
<b>Discount Houses</b>	Abrar Discounts Berhad Amanah Short Deposits Berhad KAF Discounts Berhad Malaysian Discount Berhad Mayban Discount Berhad
<b>Development Financial Institutions</b>	Bank Kerjasama Rakyat Malaysia Berhad



	Bank Simpanan Nasional Bank Pembangunan Malaysia Berhad Bank Pertanian Malaysia Bank Perusahaan Kecil and Sederhana Malaysia Berhad
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Source: Bank Negara Malaysia, <http://www.bnm.gov.my>.

In Malaysia as at June 2006, there are 1,161 branches of Islamic banks and 909 IBS counters in commercial banks channelling Islamic banking services to customers.

Table 3.4 shows that the number of IBS counters in commercial banks decreased from 1,553 in 1998 to 1,307 by 2005 and 909 in June 2006, owing to the gradual mergers in the banking sector.

**Table 3.4a** No. of financial institutions offering Islamic banking services

	As at end								
	1998	1999	2000	2001	2002	2003	2004	2005	2006*
Islamic Banks	1	2	2	2	2	2	2	6	9
Commercial Banks	25	23	21	14	14	13	13	11	8
Finance Companies	18	16	14	10	10	7	3	1	0
Merchant Banks	5	5	5	5	3	4	4	4	4
Discount Houses	—	7	7	7	7	7	7	7	6

**Table 3.4b** No. of branches/IBS counters offering Islamic banking services

	As at end								
	1998	1999	2000	2001	2002	2003	2004	2005	2006*
<b>Islamic Banks</b>	80	120	122	122	128	132	136	766	1161
<b>Commercial Banks:</b>									
Fully-fledged branches	7	6	7	8	8	13	16	16	10
SPI counters	1,553	1,366	1,338	1,355	1,355	1,410	1,661	1,307	909
<b>Finance Companies:</b>									
Fully-fledged									

branches	3	2	2	2	2	7	1	1	0
SPI counters	823	735	745	730	730	646	216	32	0
<b>Merchant Banks:</b>									
SPI counters	6	6	4	—	0	—	—	9	9

Source: Bank Negara Malaysia [www.bnm.gov.my](http://www.bnm.gov.my)

Note: \*Six months ended June 2006.

An encouraging sign is that the financial liberation of the Islamic banking sector enabled three new Islamic banks from the Middle East to be established in Malaysia during 2004.<sup>109</sup> The three banks are licensed under the IBA.<sup>110</sup> These additions to the Malaysian Islamic banking system are helping to fulfil the government's vision of Malaysia as the international centre of Islamic finance.<sup>111</sup> The establishment of the following organizations related to Islamic finance shows the strong support of the Malaysian government:

1. Islamic Financial Services Board (IFSB)
2. Association of Islamic Banking Institutions Malaysia (IABIM)
3. Islamic Banking and Finance Institute Malaysia Sdn Bhd (IBFIM)
4. International Centre for Education in Islamic Finance (INCEIF)

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<sup>109</sup> Bank Negara Malaysia (2004), op. cit., p.158.

<sup>110</sup> The three leading foreign Islamic financial institutions from the Middle East are the Kuwait Finance House, al-Rajhi Banking and Investment Corporation (Saudi Arabia), and a consortium of Islamic financial institutions represented by the Qatar Islamic Bank, RUSD Investment Bank Inc. and Global Investment House.

<sup>111</sup> It is stated in the Bank Negara Malaysia (2004), op. cit., p.165 that it is hoped that the entry of the new players into the market will (1) bring their distinctive capabilities and strengths to the Islamic banking industry not only in Malaysia but also to the region; (2) promote healthy competition, necessary for the development of the industry to new levels of vitality; (3) accelerate the global integration of the domestic Islamic banking system; (4) promote greater economic and financial links between Malaysia and the Middle East owing to the exchange of knowledge and expertise; (5) foster greater harmonization in the interpretation and understanding of the Shari'a; and (6) facilitate greater international trade and investment flows.

### 3.4 Islamic Banking Products and Services in Malaysia

All Islamic banks perform the typical functions of financial intermediation by screening profitable projects and monitoring their performance on behalf of the investors who deposit their funds with these institutions. Hence, two theoretical models<sup>112</sup> have been suggested for the structure of an Islamic Financial Institution (IFI): one is based on *mudaraba* and is referred to as “two-tier *mudaraba*,” and the other is known as the “two-windows” model.<sup>113</sup>

The “two-tier *mudaraba*” uses a concept whereby both fund mobilization and fund utilization work on the same basis of profit sharing by the investor (depositor), the bank as intermediary, and the entrepreneur. The first tier of this type of contract is between the investor and the bank. The bank, as *mudarib*, will accept funds from investors on their behalf, and the investors will share the profits (if any) earned by the bank from their investments. In other words, funds are placed with the bank in investment accounts as profit-sharing investment deposits, and the bank has no liabilities to these funds. The capital is not guaranteed, for if the bank declares losses, these will also be borne by the investors. As an addition to this model, the bank can also accept investments as demand deposits, which are treated as liabilities although they yield no return and are payable on demand at par value or face value. The second tier represents the *mudaraba* contract between the bank as the supplier of funds and the entrepreneur as the *mudarib*. The same principles apply to this con-

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<sup>112</sup> These two theoretical models are analysed briefly in Chapter 4.

<sup>113</sup> Dahlia el-Hawary, A. Wafik Grais and Zamir Iqbal, “Regulating Islamic Financial Institutions: The Nature of the Regulated”. Paper presented at the International Conference on Islamic Banking: Risk Management, Regulation and Supervision. Jakarta, 30 September – 2 October 2003.

tract, for entrepreneurs who are seeking funds will share with the bank whatever profits they make, according to a certain percentage stipulated in the contract.

The “two-windows” model differs from the “two-tier” model in that it is a combination of commercial banking and investment companies in the conventional system. In this model, bank liabilities are divided into two “windows”: one for demand deposits and the other for investment deposits. Since demand deposits are strictly liabilities to the bank, this model requires that the bank hold a 100 per cent reserve to guarantee them. However, for investment deposits, there is a zero per cent reserve, since they are not strictly liabilities and are used by the bank to finance risk-bearing investment projects. On the assets side, the bank will invest in short-term,<sup>114</sup> medium-term and longer-term maturity investments. Therefore, this model is the one-tier *mudaraba* with multiple investment tools. It has opted for fixed-income modes of financing such as *murabaha* (mark-up sales), *al-bay‘ bi thamam ajil* (deferred payment) and so on.

Section 3.3 has described how the Malaysian government has adopted a systematic approach to the development of Islamic banking by acknowledging the right of Muslim citizens to be provided with banking services consistent with their faith values. Islamic banking has grown steadily in Malaysia, which is considered a Muslim country that has successfully promoted this system on a par with its conventional counterpart. Nevertheless, some local products are not accepted globally

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<sup>114</sup> In a short-term maturity investment, a bank can provide short-term funds to its clients to meet their working capital needs if the funds are backed by real assets to minimize the risk to the bank. The banks, with their skills and market knowledge, also provide financing trade activities with asset-backed securities that resemble debt securities in terms of pay-offs.

owing to objections from scholars of other countries, who doubt that the system complies fully with the principles of the Shari‘a.<sup>115</sup>

The next section reviews briefly the model adopted in the Islamic banking system in Malaysia and the critiques of some of its products, as well as the range of products and services offered by the Islamic banks and the Shari‘a principles observed by them.

### **3.4.1 The Islamic Banking Model in Malaysia**

In Malaysia, the Islamic commercial banks follow the “two-windows” model. In section 3.3, it is stated that all the Islamic banks and conventional banks in Malaysia have followed the model of the first Islamic bank in Malaysia, namely, the Bank Islam Malaysia (BIMB). BIMB applies the principles laid down by its founder, Dato Dr Abdul Halim Ismail, who adapted the model of commercial banking to Islamic banks. This decision was probably influenced by the large non-Muslim population, which does not view banks as instruments of social engineering<sup>116</sup> as well as by several other factors that have been discussed in detail in section 3.3.

Abdul Halim Ismail, who was the first Managing Director of BIMB, viewed Islamic banks as commercial entities that had a responsibility to transact business in a manner consistent with the Shari‘a.<sup>117</sup> In his model, the banks’ main responsibility is to shareholders and depositors, while social welfare objectives are to be fulfilled

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<sup>115</sup> Halim Wahab, “The Debate Continues”, *Malaysian Business* (16 May 2004), pp.38–39.

<sup>116</sup> Elsa Satkunasingam and Bala Shanmugam, “Disclosure and Governance of Islamic Banks: A Case Study of Malaysia”, *Journal of International Banking Regulation*, vol.6, no.1 (2004), pp.69–81. Here, the authors are referring to Chapra’s model, which sees Islamic banking as having a socio-economic purpose.

<sup>117</sup> Abdul Halim Ismail, “Bank Islam Malaysia Berhad: Principles and Operations”, in *An Introduction to Islamic Finance*, ed. Shaikh Ghazali Sheikh Abod, Syed Omar Syed Agil and Aidit Hj. Ghazali (Kuala Lumpur: Quill Publishers, 1992a), pp.243–83.



by other bodies, such as the government. This model provides an Islamic economic system consisting of three sectors: *siyasi* (government), *ijtimai* (welfare) and *tijari* (commercial). *Siyasi* deals with public finance and central banking, *ijtimai* is responsible for the administration of taxes, and *tijari* covers all private sector commercial activities. There are several different types of institutions in each of these sectors, all functioning according to the general Shari'a principles, though with a particular application to the operation undertaken.

The Islamic financial system comprises institutions from each of the three sectors. Within this framework, the Islamic commercial banks clearly belong to the *tijari* of the commercial sector and therefore their responsibilities are limited to commercial activities. They are not required to ensure an equitable distribution of income, which is the task of public finance and therefore the concern of the *siyasi*, the government sector. Similarly, the commercial banks are not responsible for the collection of taxes and distribution of the funds thus accumulated, for that function is performed by the various *ijtimai* institutions. The Islamic banking models that have been implemented in Malaysia are those of commercial institutions, with their fundamental responsibilities to shareholders and depositors. Their obligations to society are served by their self-interest as well as the distribution of profit and *zakat*.

Abdul Halim's framework is different from earlier models, like that of Chapra, which sees Islamic banks not only abolishing *riba* in their transactions, but also having a socio-economic purpose, thus making them significantly different from conventional interest-based banks.<sup>118</sup> Islamic banks should actively promote Islam

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<sup>118</sup> M. Umer Chapra, *Towards a Just Monetary System* (Leicester, UK: The Islamic Foundation, 1985), pp.154–155.

and protect the needs of the society as a whole, instead of just playing a profit-maximizing role. This model also regards Islamic banks as universal or multi-purpose, rather than purely commercial institutions. In short, it can be concluded that the main aim of Chapra's model is the allocation of social welfare responsibilities and religious requirements to all levels of the financial system, ranging from the central bank to private commercial banks and the deposit insurance and audit corporations. This communal role clearly adds an extra dimension to the objective function of the Islamic financial agent.

The Malaysian system also allows the trading of receivables based on true trade transaction as opposed to the lending of money. However, this practice raises the question of whether certain instruments offered in the country are Islamic, for it contradicts the view widely held in the Arabian Peninsula and South Asia. Indeed, Abdul Halim believes that in its opposition to interest-based loans, the Qur'an refers to universal debt instruments based on trade, including sales and leasing.<sup>119</sup> Adam and Thomas state their argument as follows:

Although the fundamental argument that debt-like behaviour, leasing for instance, is permitted, the idea that a stream of payments alone is eligible for trading is rejected on the ground that in the case of sale with deferred payment, buying the receivables at a variable price is the same as buying or selling cash alone and this is analogous to behaviour that was forbidden in the *hadith* as *ribawi*.<sup>120</sup>

The argument in the Arabian Peninsula and South Asia is expressed by Mufti Taqi Usmani as follows:

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<sup>119</sup> Nathif Adam and Abdulkader Thomas, *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk* (London: Euromoney Books, 2004), p.48. See also, Abdul Halim Ismail, "The Deferred Contracts of Exchange in al-Qur'an", in *Bank Islam Malaysia Berhad: Principles and Operations*, ed. Sheikh Ghazali Sheikh Abod, Syed Omar Syed Agil and Aidit Hj. Ghazali (Kuala Lumpur: Quill Publishers, 1992b), pp.284–313.

<sup>120</sup> Ibid.

Some scholars argue that the permissibility of sale of debt (*bai' al-dain*) is restricted to a case where the debt is created through a sale of commodity. In this case, they say, the debt represents the sold commodity as its sale may be taken as a sale of the commodity. The arguments, however, are devoid of force. For once the commodity is sold, its ownership is passed on to the purchaser and it is no longer the commodity of the seller. What the seller owns is nothing more than money, therefore if he sells the debt, it is no more than a sale of money and it cannot be termed by any stretch of the imagination to be a sale of commodity. That is why this view has not been accepted by the overwhelming majority of the contemporary scholars. The Islamic Fiqh Academy of Jeddah, which is the largest representative body of the Shar'ia scholars and has the representation of all the Muslim countries, including Malaysia, has approved the prohibition of *bai' al-dain* unanimously without a single dissent.<sup>121</sup>

As has been emphasized by Mufti Usmani, the traditional Muslim jurists (*fuqaha*) are unanimous on the point that the sale of a debt is not allowed in the Shari'a.<sup>122</sup> However, Shafi'i scholars in Malaysia permit debt trading from sales receivables, whereas this practice is not permitted by Shafi'i scholars elsewhere.<sup>123</sup> Mufti Usmani also points out that although the Shafi'i scholars in Malaysia normally refer to the ruling of the Shafi'i school, wherein it is held that the sale of a debt is allowed, they ignore the fact that the Shafi'i jurists have allowed it only where a debt is sold at its par value.<sup>124</sup>

### **3.4.2 Shari'a Principles, Islamic Banking Products and Services in Malaysia**

This section reviews the Shariah principles used in the Islamic banking system in Malaysia. They can be divided into five broad categories: (1) profit/loss sharing; (2) sales and purchase; (3) fee or charge-based; (4) free services; and (5) ancillary.

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<sup>121</sup> Mufti Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (New Delhi: Idara Isha'at-e-Diniyat, 1999), pp.217–218. See also, Mufti Muhammad Taqi Usmani, *Principles of Shariah Governing Islamic Investment Funds* (cited 1 June 2006), [www.albalagh.net/Islamiceconomics/finance.shtml](http://www.albalagh.net/Islamiceconomics/finance.shtml).

<sup>122</sup> Ibid.

<sup>123</sup> Ibid.

<sup>124</sup> Ibid.

There are various terms used by Islamic banks all over the world to describe the Shari'a principles applied to the products and services offered by their organizations. Some banks use only the Arabic language for these terms, some use Arabic for certain terms and the vernacular for others, and some use only the local language for all the terms. Malaysia is the only country where Arabic is used to describe all the Shari'a principles governing its Islamic banking operations.<sup>125</sup>

#### **3.4.2.1 APPLICATION OF SHARI'A PRINCIPLES TO THE ISLAMIC BANKING SYSTEM IN MALAYSIA<sup>126</sup>**

The Shari'a principles used by the Islamic banks in Malaysia are as follows:<sup>127</sup>

1. *Wadiah yad dhamanah* (savings with guarantee) refers to goods or deposits left for safekeeping with another person who is not the owner. Since *wadiah* is a trust, the depository becomes a guarantor and therefore guarantees repayment on demand of the whole amount or the deposit, or any part thereof, outstanding in the account of the depositors. The depositors are not entitled to any share of the profits although the depository may provide returns to the depositors as a token of appreciation.
2. *Mudharabah* (profit-sharing) refers to an agreement between a capital provider and another party (entrepreneur) to enable the entrepreneur to carry out business projects on a profit-sharing basis at a previously agreed ratio. Any losses incurred are borne by the provider of the funds.

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<sup>125</sup> Haron, op. cit., p.172.

<sup>126</sup> The spelling of the Arabic terms in sections 3.4.2.1, 3.4.2.2, 3.5 and Chapter 5, is that used by BNM and is therefore different from that used in the rest of the thesis.

<sup>127</sup> Bank Negara Malaysia, *Islamic Banking Concepts and Range of Islamic Banking Products and Services in Malaysia*, [www.bnm.gov.my](http://www.bnm.gov.my) (cited 24 February 2007).

3. *Musyarakah* (joint venture) refers to a partnership or joint venture for a specific business, whereby the distribution of profits is apportioned according to an agreed ratio. Any losses incurred are shared by both parties, based on their equity participation.
4. *Murabahah* (cost plus) refers to the sale of goods at a price that includes a profit margin agreed by both parties. This type of sale contract is valid on condition that the price, other costs and the profit margin of the seller are stated at the time of the sale agreement.
5. *Bai' bithaman ajil* (deferred payment sale) refers to the sale of goods on a deferred payment basis at a price that includes a profit margin as agreed by both parties.
6. *Bai' dayn* (debt trading) refers to debt financing, that is, the provision of financial resources required for production, commerce and services by way of sale/purchase of trade documents and papers. Only documents evidencing real debts arising from *bona fide* merchant transactions can be traded.
7. *Bai' inah* refers to the contract of sale by the financier to the customer. The financier sells an asset to the customer on a deferred payment and then immediately repurchases the asset for cash at a discount.
8. *Al-ijarah thumma al-bai'* refers to an *ijarah* (leasing/renting) contract, followed by a *bai'* (purchase) contract. Under the first contract, the hirer leases the goods from the owner at an agreed rental over a specific period. Upon expiry of the leasing period, the hirer enters into a second contract to purchase the goods from the owner at an agreed price.



9. *Ijarah* (leasing) refers to an agreement by which a lessor leases equipment, a building or other facilities to a client at an agreed rental against a fixed charge as agreed by both parties.
10. *Qard hasan* (benevolent loan) refers to non profit loan. The borrower is required to repay only the principle borrowed, although he/she can pay an extra amount, at his/her absolute discretion, as a token of appreciation.
11. *Bai' al-salam* (future delivery) refers to an agreement whereby payment is made in advance for the future delivery of specified goods.
12. *Bai' al-istijrar* (supply contract) refers to an agreement between the client and the supplier, whereby the supplier agrees to supply a particular product on a continuing basis at an agreed price and according to an agreed mode of payment.
13. *Kafalah* (guarantee) refers to a contract of guarantee by the contracting party or any third party to guarantee the performance of the contract terms by the contracting parties.
14. *Rahn* (collateralized borrowing) refers to an arrangement whereby an asset is placed as collateral for debt. The collateral may be disposed of in the event of default.
15. *Wakalah* (nomination of a representative/agent) refers to a situation where one person nominates another person to act on his/her behalf.
16. *Hiwalah* (remittance) refers to a transfer of funds/a debt from the depositor's/debtor's account to the receiver's/creditor's account, and a commission may be charged for this service.
17. *Sarf* (foreign exchange) refers to the buying and selling of foreign currencies.

18. *Ujr* (fee) refers to a commission or fees charged for services.
19. *Hibah* (gift) refers to a gift awarded voluntarily in return for a loan.

### 3.4.2.2. ISLAMIC BANKING PRODUCTS AND SERVICES AVAILABLE IN MALAYSIA

Tables 3.5(a) to 3.5(f) list some of the range of Islamic banking products and services in Malaysia, consisting of deposits, financing, treasury/money market investments, trade financing, card services and banking services.

**Table 3.5(a)** Deposit and Investment

<b>Products/Services</b>	<b>Applicable Concepts</b>
Current account	<i>Wadiah yad dhamanah /mudharabah</i>
Savings account	<i>Wadiah yad dhamanah / mudharabah</i>
General investment account	<i>Mudharabah</i>
Special investment account	<i>Mudharabah</i>
Other deposits	<i>Murabahah/ tawarruq</i>

**Table 3.5(b)** Financing (fund-based)

<b>Products/Services</b>	<b>Applicable Concepts</b>
Asset Financing	<i>Tawarruq/murabahah/mudharabah/musyarakah</i>
Asset-backed financing	<i>Ijarah</i>
Benevolent loan	<i>Qard</i>
Block discounting	<i>Bai' dayn</i>
Bridging finance	<i>Istisna'/'bai' bithaman ajil</i>
Bungalow lots financing	<i>Bai' bithaman ajil</i>
Cash line facility	<i>Bai' 'inah/bai' bithaman ajil</i>
Club membership financing	<i>Bai' bithaman ajil</i>
Computer financing	<i>Bai' bithaman ajil</i>
Contract financing	<i>Bai' bithaman ajil/istisna' / musyarakah/mudharabah</i>
Education financing	<i>Murabahah/ bai' bithaman ajil/bai' 'inah</i>
Equipment financing	<i>Bai' bithaman ajil</i>
Factoring facility	<i>Bai' dayn</i>
Fixed asset financing	<i>Bai' bithaman ajil</i>
Floor-stocking financing	<i>Murabahah/bai' bithaman ajil</i>
Hire purchase agency	<i>Wakalah</i>
Home/house financing	<i>Bai' bithaman ajil/istisna' /variable rate bai' bithaman ajil</i>
Industrial hire purchase	<i>Ijarah</i>
Land financing	<i>Bai' bithaman ajil</i>
Leasing	<i>Ijarah</i>
Pawn broking	<i>Rahnu (qard and wadiah yad dhamanah)/ Rahnu (qard)</i>
Personal financing	<i>Bai' bithaman ajil/murabahah/bai' 'inah</i>
Plant and machinery financing	<i>Bai' bithaman ajil/istisna' / ijarah</i>
Project financing	<i>Bai' bithaman ajil/istisna' /ijarah</i>
Property financing	<i>Bai' bithaman ajil/istisna' /variable rate ijarah</i>

Revolving credit facility	<i>Bai' bithaman ajil/murabahah/hiwalah/bai' 'inah</i>
Share financing	<i>Bai' bithaman ajil/bai' 'inah</i>
Shop house financing	<i>Bai' bithaman ajil/istisna'/variable rate bai' bithaman ajil</i>
Sundry financing	<i>Bai' bithaman ajil</i>
Syndicated financing	<i>Istisna'/bai' bithaman ajil/ijarah thumma al-bai'</i>
Term financing	<i>Bai' bithaman ajil/ variable rate bai' bithaman ajil</i>
Tour financing	<i>Bai' bithaman ajil</i>
Umrah and visitation financing	<i>Bai' bithaman ajil</i>
Vehicle/automobile financing-i	<i>Ijarah/bai' bithaman ajil/murabahah</i>
Working capital financing	<i>Murabahah/bai' bithaman ajil/tawarruq/murabahah/musyarakah/mudharabah</i>

**Table 3.5(c) Fee-based**

<b>Products/Services</b>	<b>Applicable Concepts</b>
Accepted bills	<i>Murabahah/ bai' dayn</i>
Bank guarantee	<i>Kafalah</i>
Bills of exchange	<i>Wakalah</i>
Export credit refinancing	<i>Murabahah</i>
Letter of credit	<i>Wakalah/murabahah/ijarah/ bai' bithaman ajil</i>
Shipping guarantee	<i>Kafalah</i>
Trust receipt	<i>Wakalah/murabahah</i>

**Table 3.5(d) Trade financing**

<b>Products/Services</b>	<b>Applicable Concepts</b>
Accepted bills	<i>Murabahah/ bai' dayn</i>
Bank guarantees	<i>Kafalah</i>
Bills of exchange	<i>Wakalah</i>
Export credit financing	<i>Murabahah/ bai' dayn</i>
Letters of credit	<i>Wakalah/murabahah/ijarah/bai' bithaman ajil</i>
Shipping guarantees	<i>Kafalah</i>
Trust receipts	<i>Wakalah/murabahah</i>

**Table 3.5(e) Card services**

<b>Products/Services</b>	<b>Applicable Concepts</b>
Charge card	<i>Qard</i>
Credit card	<i>Bay' 'inah/bai' bithaman ajil</i>
Debit card	<i>Ujr</i>

**Table 3.5(f) Banking services**

<b>Products/Services</b>	<b>Applicable Concepts</b>
Stock broking services	<i>Ujr</i>
TT/funds transfer	<i>Ujr</i>
Travellers' cheques	<i>Ujr</i>
Cashiers' orders	<i>Ujr</i>
Demand drafts	<i>Ujr</i>
Standing instructions	<i>Ujr</i>
ATM services	<i>Ujr</i>
Tele banking	<i>Ujr</i>

### 3.5 Implementation of Profit/ Loss-Sharing Modes of Financing by the Malaysian Islamic Banking System

As mentioned in section 3.4, although the development of products and services in the Islamic banking system in Malaysia is very encouraging, those products in financing activities under the profit/loss-sharing principles are almost non-existent. On the other hand, Islamic banking assets (financing activities) are concentrated in certain contracts such as *al-bai' bithaman ajil*, *al-murabahah* and *al-ijarah*. One of the factors contributing to the low occurrence of financing activities in profit/loss sharing is the theoretical model that they follow. Although the Islamic banking system is often described as consisting of profit/loss-sharing financial institutions, and the concept of profit/loss sharing has dominated the theoretical literature,<sup>128</sup> the allocation of most Islamic funds is confined to short-term and low-risk investments with a slim profit margin. Islamic banks prefer to operate according to principles within the fee-based category owing to its simplicity, lower risk and predetermined fixed rate of return.<sup>129</sup> However, it is believed that the use of these facilities opens a back door to interest.<sup>130</sup>

During the early years of their establishment, the concentration by the Malaysian Islamic banks, particularly Bank Islam Malaysia, on low-risk financing could be interpreted as their awareness of the fierce competition from conventional banks, which are more stable. However, continuing this type of financing at the same level

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<sup>128</sup> Humayon Dar and John R. Presley, "Lack of Profit and Loss Sharing in Islamic Banking: Management and Control Imbalances", *International Journal of Islamic Financial Services*, vol.2, no.2 (2003), pp.3-18.

<sup>129</sup> Sudin Haron and Norafifah Ahmad, "Islamic Financial System: Issues Reexamined". Paper presented at the Muzakarah Pakar: Ke arah 20% Pasaran Perbankan Menjelang 2010: Strategi Sistem Perbankan Islam. Institut Kefahaman Islam (IKIM), Kuala Lumpur, 12-13 March 2002.

<sup>130</sup> Ibid.

would not be advisable in the long term.<sup>131</sup> This circumstance raises the question of whether the essence of risking-taking and value addition, which are indispensable social imperatives and hence Islamicity, seems to have been lost.<sup>132</sup> This situation is not confined to Malaysia. Indeed, nearly all Islamic banks, investment companies and investment funds offer trade and project finance based on a mark-up, commissioned manufacturing or leasing.<sup>133</sup> In 1998, the Dubai Islamic Bank allocated only 10 per cent of its total funds to profit/loss sharing, and the Jordan Islamic Bank and the Qatar Islamic Bank 3 and 4 per cent respectively. Even the specialized Islamic firms, like the *mudaraba* companies (MCos) in Pakistan, which are supposed to function purely on a profit/loss-sharing basis, invest only a negligible proportion of their funds in the *mudaraba* and *musharaka* systems.<sup>134</sup> According to the International Association of Islamic Banks (IAIB), profit/loss sharing comprised less than 20 per cent of investments made by Islamic banks worldwide (1996 figures). Similarly, the Islamic Development Bank (IDB) has so far not used profit and loss sharing in its financial businesses, apart from a few small projects.<sup>135</sup>

It has been suggested that the Malaysian Islamic banks should diversify as a matter of urgency by promoting ethical banking via arrangements such as the trustee partnership (*mudharabah*) and the joint venture (*musyarakah*).<sup>136</sup> It is believed that in this way, Islamic banking can generate the much-needed economies of scale and

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<sup>131</sup> Saiful Azhar Rosly and Mohd Affandi Abu Bakar, "Performance of Islamic and Mainstream Banks in Malaysia", *Journal of Social Economics*, vol.30, no.12 (2003), pp.1249–1265.

<sup>132</sup> Ibid.

<sup>133</sup> Dar and Presley, op. cit., pp.3–18.

<sup>134</sup> Ibid.

<sup>135</sup> Ibid.

<sup>136</sup> Rosly and Bakar, op.cit., pp.1249–1265.



scope to increase profitability in addition to having a positive influence on the well-being of society.<sup>137</sup> In addition, Islamic banks are not only intermediaries and trustees of other people's money but also incorporate both profit and morality into their objectives; they share profits and losses with their depositors, thereby giving their depositors some ownership rights.<sup>138</sup>

In the next section, the financing activities according to contract in the Malaysian banking system are reviewed. Since Bank Islam (M) Berhad was the first Islamic bank in Malaysia, it is important to understand its direction of financing and the implementation of profit/loss-sharing in its financing activities.

### **3.5.1 Financing Activities in the Malaysian Islamic Banking System**

Table 3.6 shows that *al-bai' bithaman ajil* is the contract that has dominated financing activities in Malaysia. In 2005, financing based on these principles constituted 40.7 per cent of the financing of RM9.5 billion,<sup>139</sup> though it was a lower percentage than that of the previous four years (2001–2004). This type of financing contract was followed by *ijarah* and *murabahah*. In contrast, financing based on the *musyarakah* and *mudharabah* contracts was small or non-existent, being only 0.5 per cent in 2004 and decreasing to 0.3 per cent in 2005.

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<sup>137</sup> Ibid.

<sup>138</sup> Ibid.

<sup>139</sup> Bank Negara Malaysia, *Annual Report* (2005), pp.166–167,

**Table 3.6** Islamic financing activities in the Malaysian Islamic banking system according to contracts

Contracts	Per cent as at end				
	2001	2002	2003	2004	2005
<i>Al-bai' bithaman ajil</i>	48.3	49.1	47.7	49.9	40.7
<i>Al-ijarah thumma al-bai'</i>	22.2	23.3	27.6	—	—
<i>Al-murabahah</i>	7.0	7.3	6.2	7.0	6.9
<i>Al-musyarakah</i>	1.4	0.7	0.5	0.5*	0.3*
<i>Al-istisna'</i>	0.9	1.3	0.6	1.2	0.9
<i>Al-ijarah</i>	4.3	3.0	1.4	24.0	31.6
Other principles	15.9	15.3	16.0	17.4	19.6

Source: Bank Negara Malaysia, *Annual Report* (various issues 2001–2005).<sup>140</sup>

Note: \*This figure consists of products under *musyarakah* and *mudharabah* principles.

An analysis of the direction of financing according to the sector (Table 3.7) between 1995 and 1999 found that Islamic banking activities were dominated by the broad property sector consisting of real estate and construction. However, the trend changed between 2000 and 2005, when it was pushed into second place by consumption credit. This consisted of financing for personal users, namely, credit cards, and the purchase of consumer durables and passenger cars, the last item being the largest in this sector.

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<sup>140</sup> Bank Negara Malaysia began to classify the Islamic financing activities according to contract (as a percentage of total financing) only in 2001.

**Table 3.7** Islamic banking system: Direction of financing (RM million)

Sector	Year				
	1995	1996	1997	1998	1999
Agriculture	40	153	194	172	491
Manufacturing	757	924	1,283	1,298	1,252
Mining and quarrying	3	5	73	69	74
Electricity	62	89	99	33	221
General commerce	179	329	524	628	627
Real estate, construction and housing	1,032	2,101	4,317	4,561	2,132
Transport and storage	73	259	720	720	990
Financial, insurance and business services	289	536	306	457	901
Purchase of stocks and shares	605	503	1,128	853	745
Consumption credit	168	508	633	947	878
Others	284	737	1,475	1,205	1,855
<b>TOTAL</b>	<b>3,492</b>	<b>6,144</b>	<b>10,752</b>	<b>10,943</b>	<b>14,007</b>

Sector	Year					
	2000	2001	2002	2003	2004	2005
Agriculture, hunting, forestry and fishing	1,578	1,640	1,594	1,862	2,329	2,369
Manufacturing	2,044	3,073	3,881	4,387	6,113	7,520
Mining and quarrying	79	64	75	64	77	105
Electricity, gas and water supply	856	544	534	249	719	419
Wholesale and retail trade, restaurants and hotels	855	1,135	1,386	1,797	3,071	3,388
Real estate, construction and housing	7,506	10,783	15,736	20,483	22,451	22,923
Transport, storage and communication	788	763	825	1,024	1,177	1,287
Financial, insurance and business services	596	1,230	1,272	1,933	2,090	1,999
Purchase of securities	705	873	935	921	878	920
Consumption credit	4,043	6,813	9,287	14,872	17,803	24,376
Community, social and personal services and purchase of transport vehicles	293	353	214	303	419	635
Others	1,550	932	980	721	757	716
<b>TOTAL</b>	<b>20,899</b>	<b>28,203</b>	<b>36,719</b>	<b>48,616</b>	<b>57,884</b>	<b>66,658</b>

Source: Bank Negara Malaysia, *Annual Report* (various issues 1995–2005).<sup>141</sup>

<sup>141</sup> Bank Negara Malaysia began to classify Islamic financing activities by sector in 1995.

### 3.5.2 BIMB: Implementation of Profit/Loss-Sharing Principles in Financing Activities

As has already been discussed in section 3.4, the model followed by Bank Islam Malaysia (BIMB) is that of the “two windows”. On the Bank’s liability side, the customers’ deposits are accepted for current accounts, savings accounts, investment accounts and other deposits. On the financing side, the schemes could take two forms: equity financing (profit/loss-sharing modes of financing) and debt financing (non-profit/loss-sharing modes of financing).<sup>142</sup> The instruments available in the category of debt financing include *al-bai’ bithaman ajil*, *murabahah* and *ijarah*. These are financing schemes that generate profits within the short term and are based on a contract of exchanging goods and services for money. Under equity financing, the instruments available are *musyarakah* and *mudharabah*.

Table 3.8 shows that the percentage of the financing activities under *musyarakah* and *mudharabah* of the total financing of BIMB were low compared with other types of financing contract such as *al-bai’ bithaman ajil*. For example, according to the table, the financing contract under *al-bai’ bithaman ajil* dominated the financing activities of BIMB. It could be said that from Table 3.8, after more than twenty years of operation, BIMB has not shown much interest in offering the profit-sharing modes of financing. For example, *musyarakah* financing constitutes only about 0.48 per cent of total financing in 2005 compared with 0.02 per cent in 1988,

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<sup>142</sup> For details, see Ismail (1992a), op. cit., pp.256–274; see also, Wan Ismail Wan Jusoh, “Islamic Financial Instruments: The Case of Malaysia”, in *Islamic Financial Instruments for Public Sector Resource Mobilization*, ed. Ausaf Ahmad and Tariqullah Khan (Jeddah, Saudi Arabia: Islamic Research and Training Institute, Islamic Development Bank, 1997), pp.327–349.

an increase of just 0.46 per cent of their total financing. *Mudharabah* financing, however, increased to only 0.13 per cent from 1988 to 2005.



**Table 3.8** *Musyarakah and mudharabah vs. al-bai' bihaman ajil and murabahah financing contracts:*  
Percentage of total financing

	Year																	
	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Contract	0.02	0.02	0.01	0.01	0.37	1.78	1.68	1.18	0.10	0.81	0.40	0.58	0.42	3.25	3.53	0.63	0.63	0.48
Musyarakah	0.08	0.08	0.04	0.04	0.21	0.20	0.32	0.75	0.10	0.73	0.58	0.53	0.28	0.34	0.66	0.43	0.43	0.21
Mudharabah	75.66	75.73	69.14	71.85	68.79	68.76	69.22	59.43	66.52	71.22	69.98	65.73	62.43	61.41	56.56	62.18	69.27	65.44
Al-bai' bi thaman ajil																		
Murabahah	18.58	18.53	17.41	12.86	17.89	16.95	17.36	29.73	22.83	19.20	20.52	24.73	27.80	23.93	24.66	22.30	19.79	18.62

Source: Bank Islam Malaysia Berhad, *Annual Report* (various issues, 1988–2005).

In the direction of financing, BIMB also records a similar trend. It is clear that the broad property sector, consisting of real estate, construction and housing, dominated its financing facilities. Tables 3.8 and 3.9 indicate that the funds deposited by customers have been used to finance activities in sectors that are considered less risky, for under such contracts the price is predetermined and they generate a quick return. The tables also show that, to a lesser extent, funds are also directed to the productive sectors such as agriculture and manufacturing.

**Table 3.9** Bank Islam Malaysia: Direction of financing (RM million)

Sector	Year							
	1995	1996	1997	1998	1999	2000	2001	2002
Agriculture, mining and quarrying	41	49	157	155	188	194	394	257
Manufacturing	484	601	536	475	672	638	902	1,052
General commerce	148	123	147	334	300	136	84	220
Real estate, construction and housing	457	806	1,012	1,629	1,783	1,959	2,119	2,713
Financial, insurance and business services	41	62	42	35	84	112	85	167
Consumption credit	43	99	118	129	192	234	493	344
Others	281	306	510	340	354	888	1,375	1,392
<b>TOTAL</b>	<b>1,495</b>	<b>2,046</b>	<b>2,520</b>	<b>3,097</b>	<b>3,573</b>	<b>4,161</b>	<b>5,453</b>	<b>6,144</b>

Sector	Year		
	2003	2004	2005
Agriculture, hunting, forestry and fishing	248	171	267
Manufacturing	1,008	1,005	1,447
Mining and quarrying	29	14	14
Electricity, gas and water supplies	343	133	301
Wholesale and retail trade, restaurants and hotels	259	273	401
Real estate, construction and housing	3,526	4,164	4,538
Transport, storage and communication	94	122	173
Financial, insurance and business services	237	208	186
Purchase of securities	159	182	579
Consumption credit	572	606	932
Community, social and personal services and purchase of transport vehicles	627	988	1,384
Others	187	118	130
<b>TOTAL</b>	<b>7,194</b>	<b>7,985</b>	<b>10,351</b>

Source: Bank Islam (M) Berhad, *Annual Report* (various issues 1995–2005).

The concentration on the financing of the non-productive sector does not appear to contribute much to the economic development of the country. BIMB has clearly stated that its corporate mission is “to seek to operate as a commercial bank functioning on the basis of Islamic principles”, which would not be included towards trade-related equity participation. However, its concentration on non-profit/loss-sharing modes of financing raises the question of whether its operations and those of the Islamic banks in general are totally Islamic or whether the name is used as a “mask” placed on a conventional bank to attract funds from Muslim investors.

It is stated that there are a number of reasons for the reluctance of the modern Islamic financial system to use equity financing: (1) high risk; (2) moral hazard; (3) the banks’ lack of suitably qualified staff with the management skills to undertake this task; (4) the fact that most Islamic banks are very new and cannot afford to undertake equity financing until they are more securely established; and (5) structural and other regulatory issues.<sup>143</sup> Therefore, risk and its management, particularly in the profit-sharing modes of financing in the Islamic banking system are discussed in detail in Chapter 4.

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<sup>143</sup> Mohd Daud Bakar, “Contracts in Islamic Commercial and Their Application in Modern Islamic Financial Systems”. Teaching material used at the Centre for Research and Training, Kuala Lumpur, 2002.

# CHAPTER FOUR

## **4 The Concept of Risk**

### **Islamic Banking vs Conventional Banking**

#### **4.1 An Overview**

Chapter 3 consisted of a brief look at the global development of Islamic banking and a more detailed scrutiny of the system of profit/loss sharing in Malaysia. The global implementation of this system appears to be very low or even non-existent.<sup>1</sup> One of the main reasons for this situation is the high risk associated with this system.

Theoretically, only investment deposits should be accepted as a bank's liabilities, these funds being channelled via profit/loss-sharing contracts to the bank's assets side – the entrepreneurs. Any shock to the bank's assets would be absorbed by the risk-sharing nature of the investment deposits. It is believed that the Islamic system is a more stable alternative to that operated by the conventional banks.<sup>2</sup>

Thus, before proceeding to the discussion of risk management in the Islamic banking system in Malaysia in Chapter 5, it is vital to understand the differences in the concept of risk from both the Islamic and modern perspectives. This chapter also analyses how risk is managed in Islamic banks compared with conventional banks.

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<sup>1</sup> For example, Muhammad Anwar, "Islamicity of Banking and Modes of Islamic Banking", *Arab Law Quarterly*, vol.18, no.1 (February, 2003), p.62, notes that Islamic scholars have used a technique similar to that applied to conventional banks to measure the performance of Islamic banks. This situation confirms that globally, Islamic and conventional banks are competitors in the same business, for both are taking deposits and extending credit to customers, despite the fact that the correct application of Islamic modes would have distinguished the Islamic banks from their conventional counterparts. He further argues that the Islamic banks, which were supposed to become entrepreneurs, do not engage in trading activities because they are not interested in doing so. Instead, they prefer to loan money to the entrepreneurs, as do the interest-based banks.

<sup>2</sup> See, further discussion in section 4.5.3.



## 4.2 The Concept of Risk

Since ancient times, risk has been a familiar concept to humankind. People generally prefer certainty and security in their lives to the risk of uncertainty and insecurity. Nevertheless, the entirely rational person knows that even if all the necessary precautions have been taken, a certain amount of risk is unavoidable. Wharton contends that neither man nor organizations can survive without taking risks, for risk encompasses all human activity.<sup>3</sup> He maintains:

At one level, every decision or action carries some risk of a loss of face, status, money, health or liberty, whilst at another level, man is threatened by infections, diseases, fatal accidents, economic disaster, political upheaval, famines and the effects of environmental degradation.<sup>4</sup>

Humans, by their nature, are prone to taking various levels of risk, which is why some people are called risk takers and others risk averters.<sup>5</sup> However, most rational beings (and certainly those abiding by Islam) prefer risk aversion, and whenever a risk is taken, a price or compensation is always expected.<sup>6</sup> In other words, there is the risk that is unavoidable because it is part of life and there is the risk that stimulates productivity. It should be noted that Islam is unique in its principle of *tawakkul*, that is, the concept of reliance on God after all the necessary precautions have been taken. This topic is discussed further in section 4.4.

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<sup>3</sup> Frank Wharton, "Risk Management: Basic Concepts and General Principles", in Jake Ansell and Frank Wharton (eds), *Risk Analysis, Assessment and Management* (Chichester, UK: John Wiley, 1992), p.3.

<sup>4</sup> Ibid.

<sup>5</sup> Monzer Kahf, "Comments on Decision Making under Uncertainty", in *Islamic Banking and Finance: New Perspectives on Profit Sharing and Risk*, ed. Munawar Iqbal and David T. Llewellyn (Cheltenham, UK: Edward Elgar, 2001), p.34.

<sup>6</sup> Ibid.

#### 4.2.1 Definitions of Risk

An early definition of risk, given by the *Encyclopaedia Britannica*, is “hazard, chance of danger or loss, especially the chance of loss to property or goods.”<sup>7</sup> The term (French: *risque* [noun], *risquer* [verb]; Italian: *risco* “danger” [noun]; Spanish: *riesgo* [noun]) is derived from the Latin verb *resecare*, to cut back, shut off. It was originally a sailor’s term, referring to the Spanish noun *risco*, a steep rock; hence, the Spanish verb *arriesgar*, to run into danger, meaning literally “to go against a rock”.<sup>8</sup> The term indicates the possibility of a sailor’s having his ship wrecked by hitting a rock and can be best described as the danger of loss. Another definition of risk in the English lexicon given by the *Oxford Advanced Learners’ Dictionary* is the possibility of something bad happening sometime in the future, or a situation that could become dangerous or have a bad result. In other words, risk is always associated with uncertainty, so if something is certain, then there is no risk.<sup>9</sup>

It is stated in some literature, however, that the word “risk” has come into the English language either from the Arabic word *risq* or the Latin word *risicum*.<sup>10</sup> This unique opinion argues that it is a Greek derivative of the Arabic *risq*, which means “anything that has been given to you [by God] and from which you draw profit and has connotations of a fortuitous and favourable outcome.” It appears to relate to

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<sup>7</sup> *The Encyclopaedia Britannica*, “Risk” (Cambridge, UK: Cambridge University Press, 1910–1911), p.366.

<sup>8</sup> Ibid.

<sup>9</sup> Sami al-Suwailem in “Towards an Objective Measure of *Gharar* in Exchange”, *Islamic Economic Studies*, nos.1 and 2 (2000), p.64, states that economists usually differentiate between the terms “risk” and “uncertainty”. He quotes Knight (1921), who asserts that risk describes situations in which probabilities of different events can be “objectively” measured. Uncertainty describes situations where this measurement is not feasible. However, Takayama (1993) (also quoted by al-Suwailem) states that if subjective probabilities are used instead, and an axiomatic approach is employed, the distinction between risk and uncertainty “seems to have become mostly irrelevant”.

<sup>10</sup> Wharton, op.cit., p.4.

outcome in general, having neither positive nor negative implications.<sup>11</sup> On the other hand, the Latin word *risicum*, which originally referred to “the challenge that a barrier reef represents to a sailor and has connotations of an equally fortuitous but unfavourable event”, has been considered a more relevant word reflecting risk in the modern sense.<sup>12</sup>

#### **4.2.2 Risk in Banking**

In business, risk is classified in different ways, one of which is to separate its systematic and unsystematic components.<sup>13</sup> Systematic risk is linked to the overall market or the economy and unsystematic risk to a specific asset or business firm. Systematic risk is also known as uncontrollable risk, for the decision-maker or firm has no control whatsoever over the eventual outcome, whereas unsystematic or controllable risk is subject to change by these agents. In simple business terminology, the asset-specific unsystematic risk can be mitigated by spreading it over a large diversified portfolio, the systematic risk being non-diversifiable.<sup>14</sup> Nevertheless, some parts of systematic risk can be reduced by risk mitigation and transferring techniques, although others cannot be eliminated or transferred and must be absorbed by the banks.

Financial institutions face the following three types of risk: that, which can be eliminated; that which can be transferred to others; and that which can be managed by the institution itself.<sup>15</sup> However, the practice of financial institutions is to take up

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<sup>11</sup> Ibid.

<sup>12</sup> Ibid.

<sup>13</sup> Tariqullah Khan and Habib Ahmed, *Risk Management: An Analysis of Issues in Islamic Financial Industry* (Jeddah, Saudi Arabia: Islamic Development Bank: Islamic Research and Training Institute, 2001), p.27.

<sup>14</sup> Ibid.

<sup>15</sup> Ibid.

activities in which risks can be efficiently managed and to shift risks that can be transferred.

As in human life generally, risk is also a familiar concept in banking.<sup>16</sup> Nowadays, more than ever as a result of globalization, the information technology revolution, and so on, financial institutions – particularly banks – face more vigorous and complex competition. For example, with the expansion of advanced technology, there is an increasing level of fraud and defaulting on the repayment of loans.<sup>17</sup> However, as in other businesses, the nature of banking activities is such that nothing can be achieved without engaging in risk. In other words, to gain a high income or profit as a reward, there will always be a high risk. According to Cade, risk in banking is “exposure to uncertainty of outcome”. Exposure indicates a position or a stake in the outcome, an outcome is the consequence of a particular course of action, and uncertainty is the volatility of a potential outcome.<sup>18</sup>

In the conventional banking system, the ability to attract depositors and creditors depends on the quality of the management, especially the management of risk. This is crucial, for the objective of financial institutions is the maximization of profit and shareholder value and therefore risk management is the main influence on the survival and growth of the industry. Risk management refers to “the overall process that a financial institution follows to define business strategy, to identify the risks to

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<sup>16</sup> Eddie Cade, in *Managing Banking Risk: Reducing Uncertainty to Improve Bank Performance* (Chicago, IL: Glenlake Publishing, 1999), p.1, classifies banks as highly geared financial risk-takers.

<sup>17</sup> Examples are those of the Bank of New England, which made provision for massive bad debts in 1991, for they suffered a run on deposits and had to be supported by the government. In 1992, Barclays Bank declared the first loss in its history and had to provide £2.5 billion to cover bad and doubtful debts, while, in 1995, Barings, London’s oldest merchant bank, was brought down by losses of £830 million on a speculative proprietary position in Nikkei 225 stock index futures. See, *ibid.*, pp.1–2.

<sup>18</sup> *Ibid.*

which it is exposed, to quantify those risks, and to understand and control the nature of risks it faces".<sup>19</sup> For Bessis, risks in banking are usually defined by the adverse impact on the profitability of several distinct sources of uncertainty.<sup>20</sup> Bessis states that the capability to monitor and control risk serves several important functions, including:

1. the implementation of strategy;
2. the development of competitive advantage;
3. the measure of capital adequacy and solvency;
4. the aid to decision-making;
5. the aid to pricing decisions;
6. the reporting and control of risk; and
7. the management of the portfolios of transactions.

He also notes that "ignoring today's risk amounts to ignoring future losses and giving up taking corrective actions today to avoid them tomorrow."<sup>21</sup> Thus, risk control is very important, for it is an indication of profitability and competitive advantage. Clearly, controlling future costs is a priority, for it influences the contribution of present and future income.

#### **4.3 The Concept of Risk in Islam**

As discussed in Chapter 2, Islamic banks are not expected to have a philosophy similar to that of other business entities, which are likely to regard profit in their organization as their primary objective. Although profit in business organization is

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<sup>19</sup> Khan and Ahmed, op. cit., p.27.

<sup>20</sup> Joel Bessis, *Risk Management in Banking*, 2nd edn (Chichester, UK: John Wiley, 2002), p.12.

<sup>21</sup> Ibid.



crucial, Islamic institutions must, in theory and in practice, also incorporate the concept of morality into their aims. In Islam, making a profit entails sharing risk, which requires a sense of morality and equality. The concept of *baraka* (briefly examined in Chapter 2) clearly indicates that there is a positive relationship between the implementation of the system and prosperity, which applies not only to the individual and the community but also to the institution. Therefore, just as the philosophical foundation of Islamic banking is different from that of conventional banks, so is the management of risk.

Before discussing these points in detail, it is important to understand the concept of risk in Islam. As has been noted by Professor Mohamed el-Gari of King ‘Abd al-‘Aziz University,

The concept of risk mentioned by jurists in their studies on the theory of contract has nothing to do with the concept of risk as known in modern financial studies.<sup>22</sup>

When jurists refer to certain “risky” contracts and render them unacceptable from the Shari‘a point of view, some practitioners of Islamic finance take it as referring to risk in the jargon of finance.<sup>23</sup>

Warde also comments that in Islamic finance, with only a few exceptions, the vast majority of writings simply ignore the issue of *gharar*.<sup>24</sup> According to a survey of literature on Islamic economics, *gharar* is the nearest equivalent to the concept of risk, and this topic is discussed in the next section.

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<sup>22</sup> Mohamed el-Gari, “Credit Risk in Islamic Banking and Finance”, *Islamic Economic Studies*, vol.10, no.2 (2003), p.1.

<sup>23</sup> Ibid.

<sup>24</sup> Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh, UK: Edinburgh University Press, 2000), p.29.

#### 4.3.1 Definition of *Gharar*

The term *gharar* literally means risk or hazard, and its verbal noun *taghrir* means exposing oneself or one's property unknowingly to danger.<sup>25</sup> According to al-Zuhayli, the linguistic origin of *gharar* refers to "items with likeable appearance and disliked reality. Thus, our life on earth has been called in the Qur'an *mata'u al-ghuru* (utilities of *ghurur*), i.e., deceptive."<sup>26</sup> Buang states that the word *gharar* is derived from the root verb *gharara/gharra*, meaning to expose oneself and one's property to destruction without being aware of it.<sup>27</sup> In general, the Arabic lexicographers, such as Jawhari, Ibn Manzur and Mughri, classify the word *gharar* as a synonym of *khatar*, which broadly means danger, peril, jeopardy or risk.<sup>28</sup> Haque has a similar view, for he defines *gharar* as hazard, chance or risk.<sup>29</sup> Buang concludes that the word *gharar* in the Arabic language covers a variety of negative elements,

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<sup>25</sup> Al-Saddiq M. al-Amin al-Darir, *Al-Gharar in Contracts and Its Effects on Contemporary Transactions*. (Jeddah, Saudi Arabia: Islamic Development Bank: Islamic Research and Training Institute, 1997), p.10.

<sup>26</sup> Wahbah al-Zuhayli, *Islamic Jurisprudence and Its Proofs: Financial Transactions in Islamic Jurisprudence*, [*al-Fiqh al-Islami wa Adillatuh*], trans. Mahmoud A. el-Gamal, vol.1 (Damascus: Dar al-Fikr, 2003), p.82.

<sup>27</sup> Ahmad Hidayat Buang, "The Prohibition of *gharar* in the Islamic Law of Contracts: A Conceptual Analysis with Special Reference to the Practice of Islamic Commercial Contracts in Malaysia". Unpublished PhD thesis, University of London, 1996, p.130. The author also states that although there is an unfounded assertion that the word *gharar* is of Persian origin, there is no suggestion that the word is not Arabic.

<sup>28</sup> Ibid.

<sup>29</sup> Ziaul Haque, *Landlord and Peasant in Early Islam: A Study of the Legal Doctrine of Muzara'a or Sharecropping* (Islamabad: Islamic Research Institute, 1977), p.12. He says: "In the legal terminology of the *fuqaha*, it is the sale of a thing which is not present at hand; or the sale of thing whose '*aqiba* (consequences, outcome) is not known; or a sale involving risk or hazard in which one does not know whether it will come to be or not, as a fish in the water, or the bird in the air. It means that this kind of transaction (which was banned in Islam) 'in its external aspect is tantamount to deceiving the buyer, while in its internal aspects the nature of the object is not known'".

such as deceit, cheating, danger, peril and risk, any of which might lead to destruction and loss.<sup>30</sup>

#### 4.3.2 *Gharar* Sales

Although there is no direct definition of *gharar* in the Qur'an and Hadith, references to it in these sources are abundant among the examples of contracts of sales that are prohibited because they contain elements of *gharar*.<sup>31</sup> Kamali states that the term *gharar* literally means fraud (*al-khida*) and that in transactions it has often been used in the sense of risk, uncertainty and hazard. Thus, he says: "In a contract of sales, *gharar* often refers to uncertainty and ignorance of one or both of the parties over its existence at the time of contract."<sup>32</sup> Kamali asserts that, broadly speaking, *gharar* can carry different shades of meaning, depending on the transaction.<sup>33</sup> Indeed, there is no generally accepted definition of *gharar* by Muslim jurists, for they have widely differing views, though many of them define it as doubt about the existence of the subject matter of the contract.<sup>34</sup> Vogel states that as with *riba*, *fiqh* scholars have been unable to define the precise scope of *gharar*, or to come to an unanimous agreement over its meaning.<sup>35</sup> Zaki Badawi also maintained that the precise meaning of *gharar* was itself uncertain, since the literature did not give an agreed definition.<sup>36</sup> In his view, scholars relied more on enumerating individual instances of *gharar* as a

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<sup>30</sup> Buang, op. cit., p.131.

<sup>31</sup> Ibid., pp.132–134.

<sup>32</sup> Mohammad Hashim Kamali, "Uncertainty and Risk Taking in Islamic Law", *Law Journal* (International Islamic University Malaysia), vol.7, no.2 (1999), p.200.

<sup>33</sup> Ibid.

<sup>34</sup> Ibid.

<sup>35</sup> Frank E. Vogel, "Part I: The Islamic Law of Finance", in Frank E. Vogel and Samuel L. Hayes III (eds), *Islamic Law and Finance: Religion, Risk and Return* (London: Kluwer Law International, 1998), p.64.

<sup>36</sup> Zaki Badawi, "The Question of Risk", quoted by al-Suweilam, op.cit., p.1.

substitute for a precise definition of the term. Warde comments: "As in the case of *riba*, the prohibition is unequivocal though the concept itself is somewhat vague."<sup>37</sup>

El-Gamal then notes that juristic definitions of *gharar* vary and can often seem contradictory.<sup>38</sup> Thus, he also quotes al-Qaraḥī, who states:

The origin of *gharar* is that which is not known to occur or not (e.g., birds in the sky or fish in the water). On the other hand, that whose existence is known, but whose characteristics are unknown (e.g., when a seller sells that which is hidden in his sleeve), it is called *majhul* (unknown). Thus, the definitions of *gharar* and ignorance are each more general in some respects and less general in other respects....This is the reason for the (legal) scholars' differences over the natures of *gharar* and *jahalah* (ignorance).<sup>39</sup>

Generally, classical jurists agreed that *gharar* aroused suspicion of danger, owing to the uncertainty of the outcome of a contract. However, differences arose when the scholars assessed the level of *gharar* in each contract, because of the reasons that they gave for its existence.<sup>40</sup> Some of the definitions of *gharar* given by the classical jurists are as follows.

Al-Darir summarizes the definitions of *gharar* according to jurisprudence as follows:<sup>41</sup>

First, *gharar* applies exclusively to cases of doubtfulness or uncertainty, as in the case of not knowing whether something will take place or not. This excludes the unknown. The definition by Ibn Abidin is a case in point: "*gharar* is uncertainty over the existence of the subject matter of sale".

Second, *gharar* applies only to the unknown, to the exclusion of the doubtful. This view is adopted by the Zahiri School alone. Thus, according to Ibn Hazm, "*gharar* in sales occurs when the purchaser does not know what he has bought and the seller does not know what he has sold."

Third, a combination of the two categories above; *gharar* here covers both the unknown and the doubtful, as exemplified by the definition proposed by

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<sup>37</sup> Warde, op. cit., p.59.

<sup>38</sup> Mahmoud A. el-Gamal, *An Economic Explication of the Prohibition of Gharar in Classical Islamic Jurisprudence*, 2001 [cited 22 April 2004]. Available from <http://www.ruf.rice.edu/~elgamal>, p.5.

<sup>39</sup> Ibid., p.5

<sup>40</sup> Buang, op. cit, p.214.

<sup>41</sup> Al-Darir, op. cit., p.10.

Al-Sarakhsy (Hanafi School) “*gharar* obtains where consequences are concealed”. This is the view favoured by most jurists.

Al-Darir opts for the third definition, owing to its more extensive coverage of the jurisprudential elements gathered under *gharar*.

The following definitions have been collected by al-Zuhayli:

1. Al-Sarakhsy said for the Hanafi School: “*Gharar* is that whose consequences are hidden.”
2. Al-Qarafi of the Maliki School said: “*Gharar* is what is not known to exist in the future, e.g., birds in the air and fish in the water.”
3. Al-Shirazi of the Shafi‘i School said: “*Gharar* is that whose nature and consequences are hidden.”
4. Al-Isnawi of the Shafi‘i School said: “*Gharar* is that which admits two possibilities, with the less desirable one being more likely.”
5. Ibn Taymiyyah of the Hanbali School said: “*Gharar* is that whose consequences are unknown.” His student, Ibn al-Qayyim, said: “It is that which is undeliverable, whether it exists or not (e.g., the sale of a runaway slave or a runaway camel, even if they exist).”
6. Ibn Hazm of the Zahiri School said: “*Gharar* is where the buyer does not know what he bought or the seller does not know what he sold.”<sup>42</sup>

Thus, al-Zuhayli’s summarized definition of *gharar* is: “A *gharar* sale is any contract which incorporates a risk which affects one or more of the parties and may result in loss of property.”<sup>43</sup>

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<sup>42</sup> Al-Zuhayli, op. cit., p.83.

<sup>43</sup> Ibid.



Modern Islamic scholars have also outlined the definition of *gharar*. Although their interpretation of *gharar* is similar to that of the classical jurists, they define it in ways that are more appropriate to modern practices. For example, Kamali has summarized four main categories of *gharar* as uncertainty and risk in the (1) existence of the subject matter; (2) availability; (3) quantities; and (4) timing of completion and delivery.<sup>44</sup> Al-Zuhayli also contends that a *gharar* sale is (1) that which is not known to exist or not; (2) one whose measure is not known to be large or small; or (3) that which is undeliverable.<sup>45</sup> Zarga also maintains that *gharar* exists in a contract where the contractual parties rely upon something that is uncertain and unclear, owing to its risky nature, which equates the transaction to gambling.<sup>46</sup> It is worth noting that el-Gamal concludes that the term *gharar* can be best translated as “risk”, and therefore, the prohibition of *bay‘u al-gharar* is best translated as “trading in risk”.<sup>47</sup>

Some Western scholars have also expressed their views of *gharar*. Buang asserts that they have a wider perception of *gharar*, for they take historical and social factors into consideration.<sup>48</sup> It could be said that they have developed a different approach to the discussion. For instance, Coulson says that the prohibition of *gharar* is the linking of the prohibition of *riba* with that of gambling. This forms the basis of *gharar* with the aim of removing or avoiding inequality that might arise in contractual relationships, such as the delivery of profit to one party and loss to the

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<sup>44</sup> Kamali, op. cit., p.210.

<sup>45</sup> Al-Zuhayli, op. cit., p.84.

<sup>46</sup> Ibid., p.83.

<sup>47</sup> El-Gamal, op. cit., p.2.

<sup>48</sup> Buang, op. cit., p.350.

other.<sup>49</sup> Similarly, when referring to the social factors, Saleh also noted that the protection of the weak party against exploitation by the strong party is the basis of the prohibition of *gharar*. This idea has resulted in the formulation of the general rule that all transactions should be free from uncertainty and speculation.<sup>50</sup> Saleh, for instance, also states that the Qur'an prohibits games of chance (2:219 and 5:93), thus providing religious grounds for doubt about *gharar* as an important aspect of Islam, with its concern for protecting people from their own foolishness and excesses.<sup>51</sup> It did not escape the Prophet (pbuh), with his wide experience as a merchant and his deep knowledge of human nature, that it is not uncommon in secular transactions for one of the parties to be stronger than the other, or perhaps more clever or more experienced.<sup>52</sup> Thus, the disadvantaged party is in need of some protection and guidance before an agreement is concluded or a bargain struck.

On the other hand, Vogel has based the prohibition of *gharar* on a number of hadiths,<sup>53</sup> according to the degree of risk entailed: (1) pure speculation; (2) uncertain outcome; (3) unknowable future benefit; and (4) inexactitude.<sup>54</sup> He states:

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<sup>49</sup> Noel J. Coulson, *Commercial Law in the Gulf States* (London: Graham and Trotman, 1984), pp.43–44.

<sup>50</sup> Nabil A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar and Islamic Banking* (Cambridge, UK: Cambridge University Press, 1986), pp.49–50.

<sup>51</sup> Ibid.

<sup>52</sup> Ibid.

<sup>53</sup> Vogel, op. cit., pp.88-89. Among these hadiths are the following: (1) The Messenger forbade the "sale of the pebble" (*hasa*: sale of an object chosen or determined by the throwing of a pebble), and the sale of *gharar*. (2) Do not buy fish in the sea, for it is *gharar*. (3) The Messenger of God forbade [the sale of] the covering [of a mare] by a stallion. (4) The Prophet forbade the sale of the content of the womb and the udder, the sale of a runaway slave, ... and [the sale of] the "stroke of the diver" (*darbat al-gha'is*: sale in advance of the yield of a diver's dive, whenever it was). (5) Whoever buys foodstuffs should not be allowed to sell them until he has possession of them. (6) He who purchases food shall not sell it until he has weighed it (*yaktalahu*). (7) The Prophet forbade the sale of grapes before they were fully ripe and the sale of grain before it had hardened.

<sup>54</sup> Ibid.

A possible interpretation of the *gharar* hadiths is that they bar only risks affecting the existence of the object as to which the parties transact, rather than just its price. In the hadiths, such risks arise either (1) because of the parties' lack of knowledge; (2) because the object does not exist; or (3) because the object evades the parties' control. Therefore, the scholars might use one of these characteristics to identify transactions infected by the type of risk condemned as *gharar*.<sup>55</sup>

#### 4.3.3 Excessive and Trifling *Gharar*

Generally, *gharar* affects contracts of exchange (*uqud al-mu'awadat*), in particular, contracts of sale and leasing. In principle, it does not affect contracts of charity (*al-tabarru'at*), such as gifts and bequests (although there is some disagreement over this point).<sup>56</sup> Concerning the extent of the effects of *gharar*, Kamali lists four conditions for *gharar* to have legal consequences or to invalidate a contract:

1. It must be excessive, not trivial. A slight *gharar*, such as the sale of unidentical items at the same price is held to be negligible.
2. It occurs in commutative contracts (*'uqud al-mu'awadat al-malliyah*) as sale, rent or partnership, thus precluding *tabarru'at*.
3. The *gharar* directly affects the subject matter of the contract, as opposed to what might be attached to it (for example, concerning a cow, it is the animal herself, not her unborn calf).
4. The people are not in need of the contract in question. Should there be a public need (*hajjat al-nas*), *gharar*, even if excessive, will be ignored.<sup>57</sup>

Concerning the first and fourth conditions, the prohibition of *gharar* is not absolute. Instead, it is limited by the counterbalancing consideration of the removal of hardship or the general consideration of the public interest. The reason for this view is

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<sup>55</sup> Ibid., p.90.

<sup>56</sup> Kamali, op. cit., p.201.

<sup>57</sup> Ibid. Cf. al-Darir, pp.23–34. He explains in detail when *gharar* invalidates a contract.

that fulfilling the needs of the people takes priority by virtue of the Qur'anic principle of the removal of hardship (*raf' al-haraj*). For example, the Shari'a validates *salam* (advance purchase) and *istisna'* (contract of manufacture), regardless of the elements of *gharar* contained therein, simply because of the people's need for them.<sup>58</sup> It should be noted that certain schools of *fiqh* tolerate *gharar* in cases of need (*haja*) and where its avoidance would cause great difficulty.<sup>59</sup>

Kamali notes that *gharar* is divided into three levels: excessive *gharar* (*al-gharar al-khatir*), which can invalidate a transaction; slight or trifling *gharar* (*al-gharar al-yasir*), which is tolerated; and average *gharar* (*al-gharar al-mutawassit*), which falls between the two extremes.<sup>60</sup> In explaining excessive *gharar*, Ibn Rushd, for instance, says that it can originate in

1. ignorance and lack of information about the nature and attributes of an object;
2. a doubt about its existence and availability;
3. a doubt about its quantity or a requirement for exact information about its price;
4. the unit of currency in which the price is paid and the terms of its payment.<sup>61</sup>

Some jurists have tried to establish a rule or a means of measuring the level of *gharar*.<sup>62</sup> Among them is Abu al-Walid al-Baji, who considers trifling *gharar* to be a type found in nearly all contracts, although it is not a dominant element.<sup>63</sup>

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<sup>58</sup> Kamali, op. cit., p.201.

<sup>59</sup> Saleh, op. cit., p.53.

<sup>60</sup> Kamali, op. cit., p.201.

<sup>61</sup> Ibid.

<sup>62</sup> Al-Darir, op. cit., p.46.

<sup>63</sup> Ibid.

However, excessive *gharar* dominates and engulfs a contract to the extent that “it comes to characterize it” or, in other words, becomes a prominent feature thereof.<sup>64</sup> Al-Darir maintains:

It is obvious, though, that this rule does not place a clear dividing line between the excessive and the trifling or slight *gharar*, because there is a large intermediate area between “the *gharar* from which hardly a contract is free and that which so dominates the contract that it comes to characterize it.”<sup>65</sup>

He understands excessive *gharar* to mean influential *gharar* and that any other level is insignificant. He points out that otherwise, it is not feasible to give precise definitions of what might be excessive and what might be trifling, since *gharar* itself might be regarded as excessive and unacceptable under certain circumstances, yet could be judged differently under other circumstances.<sup>66</sup> Kamali concludes that *gharar* is a broad concept encompassing not only uncertainty and risk-taking, excessive speculation, gambling and ignorance of the material aspects of contracts, but also the whole range of contracts and transactions. Thus, he states that *gharar* (1) cannot be entirely eliminated from any contract; (2) is significant relative to the current conditions of society and traditions; and (3) has a strong element of subjectivity and value judgement, which has led to differences among jurists.

#### **4.3.4 *Gharar* vs. Risk**

From the above discussion, it should be noted that there is a difference in the concepts of risk and *gharar*. *Gharar* is a legalistic concept that arises in the contractual relationship, and that is independent of the parties concerned, whereas risk is associated with individuals and their decisions.<sup>67</sup> Therefore, a contract might be risky

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<sup>64</sup> Ibid.

<sup>65</sup> Ibid.

<sup>66</sup> Ibid.

<sup>67</sup> Kahf., op. cit., p.32.



for one party, yet less so for the other. Kahf explains that *gharar* is frequently used interchangeably with “ignorance”, for it is ignorance of either the existence of an outcome or the characteristics of an outcome whose existence is well known. However, *gharar* is more general than ignorance, for although everything containing ignorance is *gharar*, not all *gharar* is due to ignorance.<sup>68</sup> As al-Zuhayli points out: “There is no ignorance (*jahalah*) without excessive risk (*gharar*).”<sup>69</sup>

El-Gari explains that there are several differences between *gharar* sales and risk in modern financial terminology, although there are also some similarities between them.<sup>70</sup>

1. *Gharar* relates to a defect in the “form” of a contract, which creates a risk, although risk in itself does not lead to the vitiation of a contract. The financial meaning of risk is related to the circumstances of the operations resulting from the contract, whereby the objective of the party concerned might not be achieved. *Gharar* pertains to the contractual relationship and depends on the form of the contract. Risk, on the other hand, is related to the outcome of the contract.
2. *Gharar* has a fixed meaning. Therefore, if there is no *gharar* in a contract when it is concluded, then *gharar* cannot arise later.

Kahf further notes that *gharar* does not mean deception, for it relates to the contract itself, not to a calculation in the minds of the parties concerned. Indeed, even the Shari‘a does not go beyond the contract to read the minds of the parties to it.<sup>71</sup>

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<sup>68</sup> Al-Zuhayli, op. cit., p.109.

<sup>69</sup> Ibid.

<sup>70</sup> El-Gari, op. cit., p.18.

<sup>71</sup> Kahf, op. cit., p.34.

Warde also contents that *gharar* should not be used interchangeably with the broad concept of risk.<sup>72</sup> He clarifies this point as follows:

*Gharar* is prohibited, yet it would be nonsensical to prohibit risk. Islam does not even advocate the avoidance of risk. Indeed, incurring commercial risk is approved, even encouraged, provided it is equitably shared. More accurately, *gharar* refers to aleatoric transactions – that is, transactions conditioned on uncertain events.<sup>73</sup>

The Shari‘a’s principles of *al-kharaj bi al-daman* (entitlement to return an asset, resulting from assuming the risk and responsibility of owning the asset) and *al-ghurm bi al-ghunm* (entitlement to a return, resulting from the liability of risk) stipulate that all the relevant parties to the commercial undertaking must bear the risk associated with the venture as a prerequisite of earning the potential return.<sup>74</sup> It should be noted that this type of risk should be distinguished from the prohibited *gharar*, which is similar to asymmetric information and moral hazard in modern terms.<sup>75</sup> In other words, money must be put to productive use and risk must be undertaken to justify the return. Furthermore, returns should not be fixed, despite the profits. The application of the maxim (*al-ghurm bi al-ghunm*) differentiates between the income from an investment contract and the prohibited *riba* income from a loan transaction. In a loan transaction, there is no undertaking of liability to justify the extra income, since the principal is guaranteed. In an investment contract, however, there is an undertaking of liability, since neither capital nor profit is guaranteed, so the extra income is justified. This arrangement reflects the Shari‘a’s commitment to ensuring fairness and justice between the contracting parties.

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<sup>72</sup> Warde, op. cit., p.59.

<sup>73</sup> Ibid.

<sup>74</sup> Zamir Iqbal and Abbas Mirakhor, “Progress and Challenges of Islamic Banking”, *Thunderbird International Business Review*, vol.41, no.4/5 (1999), p.389.

<sup>75</sup> Ibid.

Nowadays, the advances in computerization are unlikely to change the relationship and conditional aspects of *gharar*, although this modern means of communication has reduced the uncertainties of pricing, delivery and deferment.<sup>76</sup> Nevertheless, the introduction of new products and modes of transaction in banking and finance, stock markets and futures markets have brought with them new and ever more complicated levels of *gharar*, which need careful analysis and evaluation. Therefore, a certain level of risk and vagueness, which was unacceptable in earlier times, cannot be seen in the same perspective in modern market realities. For example, modern jurists have differing opinions of the validity of trading in future commodities, because it contains *gharar*. Again, this matter is open to a fresh, and preferably collective judgement or *ijtihad*.

#### **4.4 Islamic Management of Risk**

In their daily lives, people first determine the level of risk that they might face. If the level appears high, then they will try to avoid it or at least take some precautions to minimize or mitigate it. In other words, people always determine risk according to the level perceived. Then, having made a decision, they manage the risk by taking appropriate precautions. As stated by el-Gari, risk has no significance if it cannot be measured.<sup>77</sup> It should be noted that each person perceives risk differently. What some people might assess as a high level of risk, others might assess it at a lower level.

When making financial decisions, such as the choice of investments, people measure the risk entailed and the return that they can expect to receive if they decide to invest their money. This does not mean that people avoid high-risk investments. If

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<sup>76</sup> Kamali, op. cit., p.216.

<sup>77</sup> El-Gari, op. cit., p.3.

they can afford to take that risk and can take the appropriate precautions, they might decide to accept that investment. Keown et al. state that investment options have varying levels of risk and expected returns. However, the higher the risk of an investment, the greater the expected return.<sup>78</sup> Sometimes, therefore, investors choose to put their money in risky investments because of the higher expected returns that are offered. Nevertheless, they might avoid investment opportunities that entail ambiguous and unclear risk, since ambiguity itself is a form of risk. Investments having unclear risks are considered high-risk investments.<sup>79</sup> As emphasized by Keown et al., according to the theory of risk–return trade-off, additional risk will be taken if it is compensated by an additional return.<sup>80</sup> Shapiro asserts that the rule is to provide compensation appropriate for the investors, for they always prefer less risk to more risk.<sup>81</sup> Therefore, before financial decisions can be assessed and finalized, organizations try to “assess the forces that can possibly alter the course of events so as to prevent reaching the target.”<sup>82</sup> Financial decisions depend on the expected future prospects. Clearly, managing risk is crucial in today’s businesses as financial organizations try to maximize their shareholder value.

The concept of risk from the modern and Islamic perspectives has already been discussed in this chapter. It should be noted that the prohibition of *gharar* by the Shari‘a is aimed at minimizing, or even eliminating risk and hazard in contracts by imposing the appropriate rules. One reason for this view is to remove injustice from a contract where one party enjoys an absolute advantage over the other. Another

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<sup>78</sup> Arthur J. Keown et al., *Financial Management: Principles and Applications*, 10<sup>th</sup> edn (Upper Saddle River, NJ: Pearson Prentice Hall), p.14.

<sup>79</sup> El-Gari, op. cit., p.3

<sup>80</sup> Keown et al., op. cit., p.13.

<sup>81</sup> Alan C. Shapiro, *Modern Corporate Finance* (London: Collier Macmillan, 1990), p.110.

<sup>82</sup> El-Gari, op. cit., p.5.

reason is to eliminate unfair transactions, where one party might gain and the other party lose, a situation that would upset the balance of the contract. It can be said, therefore, that risk mitigation and risk management conform to Islamic principles.

Risk management under contracts of *salam* (advance payment) was widely practised in agriculture by the early Muslims of Madina and it was approved by the Prophet.<sup>83</sup> The contract of *salam* is intended to deal with the price risk, in which the farmers, although expert at crop cultivation and animal husbandry, do not have sufficient expertise in the market and trading and so have to transfer their produce on the basis of a description by someone with greater ability in dealing with the market.<sup>84</sup> Therefore, to avoid losses by the party lacking sufficient knowledge, this risky situation is taken over by another party that has the necessary expertise to deal with the market. It is also clear that although the contract of *salam* contains an element of *gharar*, it is validated by considering the public interest.

The concept of management of risk is not contrary to Islamic principles for not being dependent on God for protection. The reference is that when a man's camel bolted, having been left untethered, he said that it had been left under God's protection. The Prophet (peace be upon him) asked the man to take the appropriate precautionary measures of safety and then trust in God.<sup>85</sup> This hadith shows that people are required to plan and manage their daily lives to obtain lawful benefits. In short, the management of risk, as employed in the above example, to minimize loss

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<sup>83</sup> El-Gari, op. cit., p.6.

<sup>84</sup> Ibid.

<sup>85</sup> Mohd Ma'sum Billah, *Islamic Law of Trade and Finance*, 2nd edn (Kuala Lumpur: Ilmiah Publishers, 2003), p.151. The Prophet (pbuh) once asked a Bedouin who had left his camel untethered: "Why do you not tether your camel?" The Bedouin answered: "I put my trust in God." The Prophet (pbuh) then said: "Tether your camel first and then put your trust in God." (Hadith narrated by al-Tirmidhi.)



in one's economic activities, is not against the Will of God. Indeed, after all the appropriate precautions have been taken, people can then rely on God (*tawakkul*), for they have done everything possible to protect their "belongings". It should be noted that according to Islam, human beings are only the vicegerents, and everything in this world belongs to God (as discussed in detail in Chapter 2). Therefore, whatever profit or loss is made by Muslims is viewed as sustenance from God and they should be satisfied with it.

#### **4.4.1 Types of Risk in Islamic and Conventional Banking Compared**

As discussed in Chapter 2, the primary function of a financial intermediary is the mobilization of savings from the savers of funds to the users of funds. Both Islamic and conventional banks perform this function by pooling small savings from households to finance productive businesses, whether small or large. The depositors or savers might be reluctant to make the investments themselves, or lend their money directly, or take equity in a borrowers' project, since they do not have the necessary knowledge or expertise, the lack of which can lead to moral hazard and asymmetric information. In conventional commercial banking, the depositors, as creditors, transfer the risk to the bank, which, in turn, might transfer the risk to the borrowers as the debtors. Under this system, the customers have the privilege of knowing the exact amount of return to expect from their deposits. However, the customers of Islamic banks do not have this information. Therefore, it is likely that the customers of conventional banks base their decisions on existing information, whereas the customers of Islamic banks have to rely on historical facts and make assumptions about the future.

In Islamic banking, since the Islamic theory of finance rejects the principle of risk transfer and the mechanism of a fixed rate of interest, the investors (depositors), the intermediary, and the entrepreneur (borrower) are subject to risk and uncertainty in the investment projects. It should be noted that the important feature of Islamic financial institutions is that in line with the prohibition of the payment and receipt of a fixed or predetermined rate of interest, the rate of return is not known and is not fixed. The rate of return can be determined only *ex post* or on the basis of the actual profit accrued from real sector activities.<sup>86</sup> There are two intermediation models in Islamic banking – “two-tier *mudaraba*” and “two windows” – each having a different level of exposure to risk.

As intermediaries, both Islamic and conventional banks face many types of risk that affect their ability to compete and meet the interests of their stakeholders, that is, their depositors, shareholders and regulators. Therefore, they need to develop systems to manage risk. It is the responsibility of supervisors and regulators to create within their banks a culture of extreme caution about exposure to risk. The features and intermediation model of the Islamic banks expose them to particular risks that need to be recognized for their management to be truly effective.<sup>87</sup> Khan and Ahmed conclude that the nature of some of the risks faced by Islamic banks are different from those faced by conventional banks.<sup>88</sup> They divide these risks into two categories: (1) risks that are commonly faced by conventional banks, such as credit risk, market risk, operational risk, and so on; and (2) risks that stem from the profit/loss-

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<sup>86</sup> V. Sundararajan and Luca Errico, “Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead” (International Monetary Fund [IMF], 2002), p.20.

<sup>87</sup> Ibid., p.4.

<sup>88</sup> Khan and Ahmed, op. cit., p.161.

sharing feature of Islamic banking. Although Islamic banks share the same risks in the first category as their conventional counterparts, the magnitude of some of them is different owing to the Islamic banks' compliance with the Shari'a. The risks in the second category are covered in detail in section 4.5. The discussion here is a comparison of the risks in Islamic and conventional banking (see Table 4.1).

**Table 4.1** Comparison of Islamic and conventional banking

Features	Islamic Banking	Conventional Banking
<b>Guarantee of the capital value of:</b> Demand deposits Investment deposits	Yes No	Yes Yes
<b>Rate of return on deposits:</b> Demand deposits  Investment Deposits	Never remunerated <sup>(a)</sup>  Uncertain, not guaranteed (ex-post realized)	Certain and guaranteed (ex-ante predetermined and fixed up front)
<b>Duration</b>	Short-term	Short-term
<b>Mechanism to regulate final returns on deposits</b>	Depending on bank performance/profits from investment.	Irrespective of bank performance/profits from investment
<b>Islamic and conventional banks, as illustrated in (PLS) principles applies</b>	Yes	No
<b>Use of Islamic modes of financing: PLS and non-PLS modes</b>	Yes	Not applicable
<b>Financing and Investment</b>	Rate of return: ex-ante predetermined and fixed up front	Rate of return: floating
<b>Duration</b>	Long-term	Long-term
<b>Use of discretion by banks with regard to collateral</b>	Not allowed to reduce credit risk in PLS modes <sup>(b)</sup> Allowed in non-PLS modes	Yes, always

*Source:* Adapted from Sundararajan and Errico (2003).

*Notes:* <sup>(a)</sup> In Malaysia, some Islamic banks, for example, Bank Islam (M) Berhad, normally give a *hiba* (gift) to the depositors. However, this is at the bank's discretion.

<sup>(b)</sup> Sundararajan and Errico state that some scholars argue that as an exception to this general rule, banks might occasionally require collateral to reduce moral hazard.

It has been mentioned in section 4.2.2 that risk in banking is divided in two types: systematic and unsystematic. According to Santomero, risk in banking is divided into six generic types: (1) systematic or market; (2) credit; (3) counterparty; (4) liquidity; (5) operational; and (6) legal.<sup>89</sup> Bessis divides risk in banking into seven types: (1) credit; (2) interest rate; (3) market; (4) liquidity; (5) operational; (6) foreign exchange; and (7) other risks, such as country, settlement, performance and solvency risk.<sup>90</sup> Below is a discussion of some of these risks in Islamic and conventional banking.

#### **4.4.1.1 SYSTEMATIC RISK**

This is sometimes described as market risk and “is the risk of asset value change associated with the systematic factor.”<sup>91</sup> The systematic market risk is the result of the overall movement of prices and policies in the economy.<sup>92</sup> This type of risk can be hedged, though not completely diversified.<sup>93</sup> It can also be classified as equity price, interest rate, currency and commodity price risk. In conventional banking, interest rate risk is one of the major problems with which banks have to contend.<sup>94</sup> Since Islamic banks do not deal in *riba* or interest-based transactions and instruments, it is argued that they do not face this type of risk. Nevertheless, according to

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<sup>89</sup> Anthony M. Santomero, “Commercial Bank Risk Management: An Analysis of the Process”, *Journal of Financial Services Research*, vol.12, nos.2/3 (1997), p.88.

<sup>90</sup> Bessis, op. cit., p.12.

<sup>91</sup> Santomero, op. cit., p.88.

<sup>92</sup> Khan and Ahmed, op. cit., p.28.

<sup>93</sup> Santamero, op. cit., p.88.

<sup>94</sup> Interest rate risk is the exposure of a bank’s financial condition to the movement in the interest rate.

Chapra and Khan, Islamic banks can face this type of risk, also known as the rate of return risk, in the mark-up price of deferred sales and lease-based transactions.<sup>95</sup>

Islamic banks use the underlying market interest rate (usually LIBOR) as a benchmark for pricing their financing facilities, specifically in a *murabaha* (mark-up) contract.<sup>96</sup> The mark-up rate is fixed for the duration of the contract, whereas the benchmark rates change. Islamic banks are exposed to the risk of change in the LIBOR rate, for it alters the value of the *murabaha* (mark-up) contract.<sup>97</sup> A rise in LIBOR mean a rise in the mark-up and also the payment of a higher profit to future depositors compared with those received by the banks from the users of long-term funds.<sup>98</sup> For instance, in investment or *mudaraba* deposits, the rate of the profits to be paid will have to respond to changes in the market rate of mark-up to satisfy and retain their fund providers and dissuade them from withdrawing their funds.

Chapra and Khan also point out that conventional banks try to manage interest rate, exchange rate, commodity and equity price risks by using futures, forwards,

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<sup>95</sup> M. Umer Chapra and Tariqullah Khan, *Regulation and Supervision of Islamic Banks* (Jeddah, Saudi Arabia: Islamic Research and Training Institute: Islamic Development Bank, 2000), p.55.

<sup>96</sup> Iqbal and Mirakhor, op. cit., p.399. They state: "An operational difficulty facing Islamic finance is the availability of an equity-based benchmark or reference rate (reflecting the rate of return on the real sector) for pricing assets and evaluating portfolio performance or comparing various investment alternatives. In the absence of such reference rate or benchmark, a questionable but common practice has been to use the London Inter-Bank Offer Rate (LIBOR) as a proxy."

<sup>97</sup> Chapra and Khan, op.cit., p.55.

<sup>98</sup> An increase in the benchmark rates might result in depositors (investors) in Islamic banks expecting a higher rate of return. Since the result of their investment activities can be determined only at the end of the investment-holding period, Islamic banks might be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by them, especially when the return on the assets is under-performing compared with competitors' rates. Some Islamic banks might decide to waive their rights or their entire *mudarib* share of the profits. On the other hand, in conventional banking, the asset side can be adjusted by repricing the receivable account at a higher rate. They can also attract new or future depositors by offering a higher interest on their fixed deposit accounts compared with those existing depositors, who receive fixed returns.



options and swaps contracts. In Islamic banking, however, it has not been possible to design Shari'a-compatible substitutes for the conventional risk-management instruments, since there has been no agreement so far by the *fuqaha* on the permissibility of these instruments.<sup>99</sup>

#### **4.4.1.2 CREDIT RISK**

This is "the risk that the counterparty will fail to meet its obligations timely and fully in accordance with the agreed terms."<sup>100</sup> It is the risk that the customers might default or fail to comply with their obligation to service their debts.<sup>101</sup> It occurs where a borrower, owing to his/her inability or unwillingness, does not perform according to the agreed contract. This type of risk can affect the bank's liquidity and also unfavourably affect the quality of the bank's assets. Although this type of risk can be diversified, it is difficult to eliminate it completely because part of the default risk might be the result of systematic risk.<sup>102</sup> Bessis emphasizes that credit risk is critical and the most important of all risks, since the default of a small number of customers can generate large losses, possibly leading to insolvency. In his view, default means any situation other than simple negligence.<sup>103</sup>

As in conventional banks, financing activities in Islamic banks are also exposed to credit risk. Chapra and Khan emphasize that the supervisory authorities

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<sup>99</sup> Chapra and Khan, op.cit., p.55.

<sup>100</sup> Khan and Ahmed, op. cit., p.28.

<sup>101</sup> Bessis, op. cit., p.13.

<sup>102</sup> Santomero, op. cit., p.89.

<sup>103</sup> Bessis, op. cit., p.13, states: "There are various default events: delay in payment obligation; restructuring of debt obligations due to major deterioration of the credit standing of the borrower; bankruptcies. However, simple delinquencies or payment delays do not turn out as plain defaults, within a durable inability of lenders to face debt obligations. Restructuring is very close to default because it results from the view that the borrower will not face payment obligations unless its funding structure changes. Plain defaults imply that the non-payment will be permanent."

need to be familiar with the major factors influencing the general nature of credit risk to which Islamic banks are exposed.<sup>104</sup> For example, when financing customers under the *mudaraba* system, Islamic banks cannot take any collateral or other guarantee to reduce credit risk. As a result, the exposure to credit risk is very high under this financing.

Another issue for Islamic banks to deal with is late payment by customers. Warde mentions that Islamic banks face a serious problem of late payment because “some people take advantage of every dilatory legal and religious device.”<sup>105</sup> Vogel also says that since court procedures are slow, late payment causes serious problems for Islamic banks.<sup>106</sup> Conventional banks can resort to late fees, lawsuits, bankruptcy and so on to protect their interests as lenders. However, in Islamic banking, late fees, in particular, have been classified as *riba*.<sup>107</sup> Consequently, since late payment does not entail any extra cost, some customers might take advantage of the situation.

In an effort to solve these problems, scholars have proposed expediting court procedures or imposing criminal fines on solvent debtors, whereby the fines will be

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<sup>104</sup> Chapra and Khan, op. cit., p.55, say that in general, the standing of counterparties, nature of the legal system, quality of collateral, maturity of credit facilities, size of banking and trading books, utilization of credit derivatives and internal control systems determine the level of a bank's credit risk. They also summarize the general points to be considered in assessing the credit risk of Islamic banks, which need the attention of the bank supervisors.

<sup>105</sup> Warde, op. cit., p.156. Warde quotes the Qur'an (2:280-1), which states that Islam recommends forbearance and even the cancellation of the loan when borrowers are in difficulties. He says that although under a secular system, these prescriptions can be ignored, under a religious or hybrid system, that is not possible.

<sup>106</sup> Vogel, op. cit., p.140. Vogel notes that penalties for delay, which can be applied not only to sales but also to all obligations, cannot be imposed on late payers. However, delay by one who is solvent is a sin, and therefore a crime. Except in Saudi Arabia, where those who delay payment can be imprisoned, measures such as flogging and imprisonment are no longer in use.

<sup>107</sup> Warde, op. cit., p.156. Cf. el-Gari, op. cit., p.19, who also states that some banks impose a penalty as a means of preventing late payment and then donate these amounts to charity.

paid to the government instead of the banks.<sup>108</sup> Some scholars have issued a fatwa supporting the charging of fines, although that has provoked some strong objections.<sup>109</sup>

On the other hand, el-Gari reveals that, instead of charging fines, some Islamic banks have adopted other measures to reduce the impact of late payment on their revenues.<sup>110</sup> One method is to charge a higher rate of mark-up according to the customer's assumed pattern of payment. As a result, the customer has to pay a higher deferred price. Another method is to create two payment schedules on the assumption that the customer might default on payment, and therefore the price is kept very high if payment is delayed. If the customer pays promptly according to the first schedule, part of the increased price is repaid. However, the second schedule is based on delay in payment, in which case the full price has to be repaid to the bank. El-Gari rightly points out that adding to the debt will probably lead to excess in the credit risk. He states that the purpose of the addition is to prevent default. It is not a valid way of increasing profits, for the level of risk depends on the types of customers and the choices that they make. Therefore, el-Gari agrees that to prevent late payment, the imposition of penalties, which will be distributed to charity later, is the best option.

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<sup>108</sup> Vogel, *op. cit.*, p.140.

<sup>109</sup> *Ibid.* Vogel asserts: "Classical law does not tolerate damages for lost profits (i.e., hypothetical profits, which would have occurred but for the debtor's actions) but only for actual destruction of property or actual out-of-pocket losses. Damages may include usufructs of which the creditor was wrongly deprived. Loss of use of money during delay cannot be compensated on this ground, however, since the money has no usufruct." These objections were raised because some banks, while waiting for the proposed solutions, included certain terms in their documentation. The terms required the customers to pay late penalties, which had been measured by the profit percentages earned by depositors, for apparently, the bank could have invested the unpaid amount and could have gained at least that figure.

<sup>110</sup> El-Gari, *op. cit.*, pp.19–20.

#### 4.4.1.3 OPERATIONAL RISK

This type of risk was defined by the New Basel Accord of January 2001 as “the risk of direct or indirect loss resulting from inadequate or failed internal process, people and systems.”<sup>111</sup> Bessis states that operational risk arises from different sources: (1) people; (2) processes; (3) technical; and (4) information technology.<sup>112</sup>

Human capital is a critical aspect of Islamic banking, which not only has unique features but also is considered to be still in its infancy. Here, operational risk occurs where the bank staffs do not have sufficient competence and experience to conduct Islamic banking operations. Chapra and Khan point out as well that an efficient and swift Shari‘a litigation system has not yet been established, and most levels of bank staff do not have a sound knowledge of *fiqh*.<sup>113</sup> Warde says: “Perhaps the most vexing managerial issue is lack of qualified personnel. Bank officers must possess at once management skills appropriate to a conventional institution and religious training.”<sup>114</sup> Furthermore, the Shari‘a supervisors (Shari‘a Board) are not fully aware of the implications of modern risk management. Thus, Islamic banks do not make sufficient use of many genuine instruments of risk management that certainly do not conflict with Shari‘a principles.<sup>115</sup> Clearly, the supervisory staff of Islamic

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<sup>111</sup> This is discussed in greater detail in Chapter 5.

<sup>112</sup> Bessis, op. cit., p.21. He elaborates as follows: “People risk designates human errors, lack of expertise and fraud, including lack of compliance with existing procedures and policies.... Technical risks relate to model errors, implementation and the absence of adequate tools for measuring risks.... Technology risks relate to deficiencies of the information system and system failure.” Inadequate procedures for reporting, monitoring and decision-making and inadequate procedures for processing information are among the sources of risk in the process category.

<sup>113</sup> Chapra and Khan, op. cit., p.56.

<sup>114</sup> Warde, op. cit., p.158.

<sup>115</sup> Chapra and Khan, op. cit., p.56.

banks must possess a sound knowledge of not only conventional banking but also Islamic principles and the relevant aspects of the Shari'a.

Indeed, people risk, arising from incompetence and fraud, could expose Islamic banks to reputation risk, for they bear the name of Islam. This could be very damaging to their image and performance. For instance, the spread of rumours or correct information about the performance of or any other circumstances related to any Islamic bank might influence depositors to withdraw their deposits. An example is that of the Dubai Islamic Bank, the oldest and one of the largest Islamic commercial banks, which was hit by a scandal affecting its employees in 1998.<sup>116</sup> The Bank incurred losses of \$50 million on its business loans, which had been given without complying with the Bank's credit terms. The news about the losses provoked a run on deposits, amounting in one day to \$138 million (or 7 per cent) of the Bank's total deposits. In this situation, the Dubai Central Bank and the United Arab Emirates authorities were obliged to come to the rescue by providing the necessary liquidity and guarantees to reassure depositors.<sup>117</sup>

In Islamic banks, operational risks also arise from technology, reputation and compliance with regulatory standards.<sup>118</sup> Khan and Ahmed point out that since Islamic banks operate a different type of business, the computer software available on the market for conventional banks might not be appropriate for Islamic banking information technology.<sup>119</sup> Islamic banks also face risks from the litigation system concerning their documentation and enforcement.<sup>120</sup> Khan and Ahmed explain that

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<sup>116</sup> Warde, *op. cit.*, p.155.

<sup>117</sup> *Ibid.*

<sup>118</sup> Chapra and Khan, *op. cit.*, p.56.

<sup>119</sup> Khan and Ahmed, *op. cit.*, p.55.

<sup>120</sup> *Ibid.*



since there are no standard forms of contracts for various financial instruments, Islamic banks prepare their documentation according to their understanding of the Shari'a, local laws, and their own needs and concerns. Therefore, the lack of both standardization and an effective litigation system increases the legal risks arising from Islamic contracts.

In complying with regulations, mistakes and negligence by supervisory staff expose a bank to regulatory risk and might incur penalties.<sup>121</sup> Since regulatory risk arises from changes in the regulatory work, it might also be the result of confusion, especially in Islamic banks operating in a country that has dual regulations covering a mixed system of Islamic and conventional banking. El-Hawary et al. also state: "Differences between the supervisory Shari'a boards of individual Islamic financial institutions within each country as well as differences between the regulatory bodies in various countries may create general uncertainty as to the rules to be followed."

#### **4.4.1.4 LIQUIDITY RISK**

This is the risk of a funding crisis.<sup>122</sup> It arises when "there is an unexpected decline in bank's net cash flow and the bank is unable to raise resources at a reasonable cost by either selling its assets or borrowing through the issuance of new financial instruments."<sup>123</sup> Therefore, this type of risk occurs when a bank cannot meet its obligations as they become due or to fund new profitable business.<sup>124</sup> Santamero states that this type of risk would certainly be associated with an unexpected event, such as a loss of

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<sup>121</sup> Dahlia A. El-Hawary, Wafik Grais and Zamir Iqbal, "Regulating Islamic Financial Institutions: The Nature of the Regulated." Paper presented at the International Conference on Islamic Banking: Risk Management, Regulation and Supervision, held in Jakarta, Indonesia, 30 September – 2 October 2003, p.25.

<sup>122</sup> Ibid.

<sup>123</sup> Chapra and Khan, op. cit., p.55.

<sup>124</sup> Ibid.

confidence.<sup>125</sup> Bessis emphasizes that an extreme lack of liquidity leads to the bankruptcy of the bank, although extreme conditions are often the outcome of other risks.<sup>126</sup> Chapra and Khan maintain that if a bank's assets are far larger than equity, even a small loss can be enough to eradicate the whole equity of the bank and cause it to collapse.<sup>127</sup> They state: "As a result of the contagion effect, the collapse of even a small bank has the potential of becoming a source of serious systemic instability in the payments system."<sup>128</sup> Therefore, careful liquidity management is vital to avoid being overwhelmed by serious liquidity problems.

Islamic banks, in particular, are exposed to liquidity risk owing to their limited opportunities to access funds, since borrowing money when necessary would entail dealing with interest. Islamic banks do not have an efficient mechanism for funding shortages of cash.<sup>129</sup> The absence of an active Islamic inter-bank money market has also restricted Islamic banks in efficiently managing their liquidity position. However, according to el-Hawary, the current use of secured commodity *murabaha* and short-term trade financing has given an opportunity for Islamic banks to invest their short-term surplus cash.<sup>130</sup> As a result of the unavailability of adequate investment opportunities compatible with the Shari'a, the liquidity risk appears to be low at present. However, it could increase in the future for several reasons:<sup>131</sup>

1. Most of the Islamic banks rely on current accounts, from which withdrawals can be made on demand.

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<sup>125</sup> Santomero, op. cit., p.85.

<sup>126</sup> Bessis, op. cit., p.17.

<sup>127</sup> Chapra and Khan, op. cit., p.52.

<sup>128</sup> Ibid.

<sup>129</sup> El-Hawary et al., op. cit., p.26.

<sup>130</sup> Ibid.

<sup>131</sup> Chapra and Khan, op. cit., p.56.

2. The sale of debts, which constitute a major part of their assets, is restricted by *fiqh*.
3. There has been a very slow development of Islamic financial instruments.

The third reason shows that human capital is crucial in Islamic banking as well as co-operation between the Islamic banks and the *fuqaha* for product innovation and development. In this respect, it is hoped that the establishment of the International Islamic Financial Market (IIFM) and the Liquidity Management Centre (LMC) could efficiently manage the Islamic financial institutions in their liquidity needs.<sup>132</sup> It has also been mentioned in Chapter 3 that the Bank Negara Malaysia (BNM) has developed an inter-bank investment facility, where Islamic financial institutions can obtain short-term finance from one another.

## **4.5 Profit/Loss-Sharing (PLS) Modes of Financing**

The discussion so far has shown that the majority of risks are shared by both conventional and Islamic banks. However, Islamic banks are also prone to other risks and at a higher level, owing to the required compliance with the Shari'a and the operation of the two models of banking: the two-tier *mudaraba* and the one-tier *mudaraba* (two-windows). It is important to understand fully the differences in the operation of these two models (mentioned in Chapter 3, section 3.4) before discussing the specific risks of profit/loss-sharing modes of financing, and so this topic is covered in greater detail below.

### **4.5.1 Analysis of the Two Models in Islamic Banking**

Generally, the operation of Islamic banks is similar to that of investment companies and commercial banks in the conventional system. In Islamic banking, depositors are

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<sup>132</sup> El-Hawary, op. cit., p.26.

classified as investors, though the investments are not guaranteed and are subject to the bank's performance. The investors are entitled to a share of the profits (or losses) according to the PLS ratio stipulated in their contracts. Yet, they do not have any voting rights nor can they claim a share in the ownership of the bank, and this is a situation similar to that of the depositors of commercial banks. It is also similar to that of investment companies, for although the investors share the profits generated from the companies' operations, yet they have no say in determining investment policy. Therefore, investment companies sell their capital to the public, whereas Islamic banks receive deposits from the public.

In Islamic banking, there are two models of operation, and the differences between them are detailed in Table 4.2. The analysis shows that although the "two-windows" model mobilizes deposits from the customers through investment deposits similar to "two-tier" *mudaraba*, it is different from the aspect of financing and deposit mobilizing from demand deposits. The investment deposits are used to finance risk-bearing projects. Under both models, any external shock such as economic turmoil, which would affect their investment from the asset side, could be absorbed by reducing the nominal value of the investment deposits. It means that no profit would be distributed if the banks declared their losses. If the situation worsened, deductions might be made from their investments to cover the losses. Under the "two-tier" *mudaraba* model, although demand deposits are repayable at par value on demand, the banks could use them to take on risk-bearing projects after informing the customers. This condition is not applicable to the "two-windows" model, since, under this system, the requirement of a 100 per cent reserve must be applied.

**Table 4.2** Analysis of the two models of Islamic banking operations

<b>Features</b>	<b>Two-tier <i>mudaraba</i></b>	<b>“Two-windows” (One-tier <i>mudaraba</i>)</b>
<b>Liability Side (Deposits)</b>		
Demand Deposits	Yes	Yes
Investment Deposits <sup>(a)</sup> ( <i>mudaraba</i> principles)	Yes	Yes
<b>Asset Side (Financing)</b>		
Profit-and-Loss-Sharing Modes	Yes	Yes
Non-Profit-and-Loss-Sharing Modes (Fixed-income modes of financing)	No	Yes
<b>Reserve Requirement</b>		
Demand Deposits	No	Yes (100% reserve requirement)
Investment Deposits <sup>(b)</sup>	No	No
<b>Finance Risk-Bearing Projects</b>		
Demand Deposits	Yes	No
Investment Deposits	Yes	Yes
<b>Returns on Deposits</b>		
Demand Deposits	No (must be repay- able at par value on demand)	No (must be repayable at par value on demand)
Investment Deposits	Yes (if any)	Yes (if any)

Notes: <sup>(a)</sup> Investment deposits cannot be withdrawn before their date of maturity. However, in many cases, banks do not object should the depositors wish to withdraw them (Sundararajan and Errico, op. cit., p.25).

<sup>(b)</sup> Traditionally, even if they are not classified as *amana* (deposits in trust), Islamic banks operating under the two-tier *mudaraba* model have kept substantial reserves against demand deposits and little (or sometimes none) against investment deposits (Ibid., p.24).

#### **4.5.2 Salient Features of *Mudaraba* and *Musharaka* Principles**

Table 4.3 shows that according to the *mudaraba* principles, the entrepreneur is under less control. Therefore, if banks participate in this mode of financing, they have no control over the project nor can they even monitor the activities. This situation might encourage a customer to use the funds too freely and even divert them from the main purpose of the contract. Since taking collateral to reduce credit risk is not allowed, banks have no means of security to protect their investments and ensure that the entrepreneur will not break the contract. Indeed, the death or insolvency of any of the partners will affect the project or any agreement that has been made. Moreover, all



losses will be borne by the bank unless it can be proved that they were due to the negligence or default of the entrepreneur. Nevertheless, this method of financing has some advantages. *Mudaraba* financing is very simple, therefore, if the bank plays only a minor role in these projects, it can concentrate on other business. In addition, the capital consumed is only in the form of cash, which means that the liquidity of the project is very high and participation in this kind of arrangement is less costly.

**Table 4.3** *Mudaraba* and *Musharaka* principles: characteristics and conditions

Type	Characteristics	Conditions
<p><b><i>Mudaraba</i></b><sup>(a)</sup>  “is a form of partnership where one of the contracting parties, called the <i>sahib al-mal</i> (the financier), provides a specific amount of capital and acts like a sleeping or dormant partner, while the other party, called the <i>mudarib</i> (entrepreneur), provides the entrepreneurship and management for carrying on any venture, trade, industry or service with the objective of earning profits.”<sup>(b)</sup>  The contract of <i>mudaraba</i> can be made between 2 or more people.<sup>(c)</sup>  1. Unrestricted  No specification for the place of business, the period, line of trade, industry or service, and the suppliers or customers to be dealt with.  2. Restricted  The financier imposes some restrictions on the entrepreneur. If the entrepreneur contravenes these restrictions, he/she alone is responsible for the consequences.</p>	<p><b>Capital</b>  Under this contract, the bank as investor provides the whole capital as cash to the entrepreneur, who offers his/her labour and expertise.  <b>Profit ratio</b>  The profit ratio should be agreed by all the parties concerned and fixed at the beginning of the project.  <b>Profit distribution</b>  The financial losses are borne completely by the bank, whereas the entrepreneur is liable only for his/her time and effort.  The profit, if any, is shared by all of the parties. However, if the losses are proved to be the fault of the entrepreneur, i.e., negligence or mismanagement, then he/she could be responsible for the financial losses incurred. The profit cannot be distributed until the losses incurred have been made good and the equity of the financier has been recovered.</p>	<p>Under this contract, the following conditions need to be met by all the parties concerned:  1. No collateral can be requested from the entrepreneur.  2. The profit ratio must be determined.  3. The entrepreneur has complete freedom to manage the business.  The capital must be only in the form of cash.  The contract can be revoked at any time, unless such revocation is prejudicial to the interests of the other party. It will also be dissolved by the death or insanity of any of the other parties.<sup>(d)</sup>  All losses incurred in the ordinary course of business must be charged against profit before they can be charged against the equity of the financier.  The liability of the financier is limited only to the extent of his/her contribution to the capital. The entrepreneur is not allowed to commit the business for any amount more than the capital contributed by the financier. If he/she does so, then he/she is eligible for the extra profits and responsible for the losses, if any.<sup>(e)</sup></p>

<p><b>Musharaka</b>  “is a form of business organization where two or more persons contribute to the financing as well as the management of the business, in equal or unequal proportions.”</p> <p>1. <i>Sharikat Mulk</i> (non-contractual partnership)  Implies co-ownership and comes into being when two or more persons happen to acquire joint ownership of an asset without having entered into a formal partnership agreement.</p> <p>2. <i>Sharikat ‘Aqd</i> <sup>(f)</sup>  (contractual partnership)  The parties concerned have willingly entered into a contractual agreement for joint investment and the sharing of profits and risks.</p> <p>(a) <i>Muwafadah</i>  Full authority and obligation.  (b) <i>Inan</i> <sup>(g)</sup>  Restricted authority and obligation.  (c) <i>Abdan</i>  Labour, skill and management  (d) <i>Wujud</i>  Goodwill, credit-worthiness and contacts.</p>	<p><b>Capital</b>  Two or more persons contribute to finance the project. The contributed capital can be in the form of cash, labour, management and skills or assets with an attributed monetary value.</p> <p><b>Profit Ratio</b>  The basis of the division of profit should be determined at the time of <i>musharakat ‘aqd</i>.</p> <p><b>Profit Distribution</b>  The profit is to be divided in the contractually agreed proportion. Losses, however, must be shared in proportion to the capital contributions. <sup>(h)</sup> However, if the loss is due to the negligence of the managing partner or management team, then the partner or the team shall bear the loss.</p>	<p>Under this contract, the following conditions need to be met by all the parties concerned:</p> <p>The capital contributed by the partner need not be on an equal basis. However, the capital will then be owned by the partnership. All the partners have a say in the management of the contract.  The <i>musharaka</i> terms must be voluntarily accepted by all the parties concerned. The termination of the arrangement must be clearly stated and the remaining capital distributed.</p>
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Notes: <sup>(a)</sup> Muhammad Umer Chapra, *Towards a Just Monetary System* (Leicester, UK: The Islamic Foundation, 1985), p.248, says that the term *mudaraba* is used by the Hanafi and Hanbali Schools, whereas the Maliki and Shafi‘i Schools prefer the term *qirad*. In Malaysia, although the majority of Muslims follow the Shafi‘i School, nevertheless, *mudaraba* is used.

<sup>(b)</sup> Ibid.

<sup>(c)</sup> Muhammad Akram Khan, “Types of Business Organization in an Islamic Economy”, in Sheikh Ghazali Sheikh Abod, Syed Omar Syed Agil and Aidit Hj. Ghazali (eds), *An Introduction to Islamic Finance* (Kuala Lumpur: Quill Publishers, 1992), pp.216–217.

<sup>(d)</sup> Ibid., p.221.

<sup>(e)</sup> Ibid., p.218. Khan lists the rights of the entrepreneur in *mudaraba* contracts. However, the entrepreneur is required to obtain the express consent of the financier for the following activities: (1) lending money to a third party; (2) buying goods on credit; and (3) borrowing money for the business.

<sup>(f)</sup> For a detailed discussion, see Saleh, op. cit., pp.91–94, and Chapra, op. cit., pp.251–255.

<sup>(g)</sup> Chapra, op. cit., p.259, quotes Ibn Rushd, who said: “*Inan* is the only partnership recognized by the Shafi’i and the partners must share the profits and the losses in accordance with their capital contributions.”

<sup>(h)</sup> Ibid. Chapra quotes Ibn Rushd as follows: “According to the Shafi’i School, even profits should be divided in proportion to capital contributions. This is because the contribution of labour (or skill and management) is difficult to measure and it is assumed that labour will be contributed equally. Profit, like losses, should also be in proportion to the risk shared. However, if two partners contribute to the capital and only one of them works, then, even according to the Shafi’i School, the working partner’s share in the profit should be higher.”

Under the *musharaka* modes of financing, both the bank and the entrepreneur inject capital into the project. Therefore, despite the lack of security or collateral,<sup>133</sup> the bank as shareholder/partner is included in management decisions. The bank can employ its representatives in the project to protect its investment. This means that the bank has a say in decision-making as well as in the management of the investment and the cash flow of the project. The risk faced by the business, whether it makes a profit or a loss for a given financial year, will be shared by both entrepreneur and the bank. However, as in a *mudaraba* contract, partners in a *musharaka* contract are free to leave the enterprise at any time. It should be noted that both types of contract require expertise and competence by the bank’s employees so that the projects can be evaluated and administered efficiently. Unlike a conventional bank or a mutual company, an Islamic bank must determine the profit/loss-sharing ratio at the beginning of an investment project. In addition, it must regularly audit the project to ensure an

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<sup>133</sup> Saleh, op. cit., p.94, says: “From the point of view of Islamic law, no security can be taken from the partner as such; only one sort of security is allowed, and indeed required, by some Islamic banks, such as the Faisal Islamic Bank of Sudan, and that is a security against the risk of negligence or wilful wrongdoing of the partner or his non-compliance with the terms of the partnership contract. The business risk inherent in the partnership and its outcome cannot be secured.”

appropriate valuation and control. However, these requirements should help Islamic banks to enforce stricter discipline in selecting investments with a more careful evaluation of projects and to improve the efficiency of inefficient and unproductive projects.<sup>134</sup> By using PLS modes of financing, especially in *mudaraba*, default cannot be recognized until the project is completed, unless there is evidence of negligence or mismanagement on the part of the entrepreneur. Indeed, the default of the entrepreneur means that “the investment project failed to deliver what was expected, that is, a lower-than-expected profit or none at all, or a loss.”<sup>135</sup>

#### **4.5.3 Risks of Profit/Loss-Sharing Financing (PLS) Modes**

Sundararajan and Errico state that the administration of PLS modes is more complex than conventional financing. However, they accept that the structure and balance sheet of Islamic banks and the use of PLS modes mean that Islamic banks are better placed than conventional banks to absorb external shocks.<sup>136</sup> The authors add:

In the event of operational losses, unlike conventional banks, Islamic banks have the ability to reduce the nominal value of a portion of their liabilities. As a result, solvency risks that may result from an asset–liability mismatch are typically lower in Islamic banks than in conventional banks.

El-Gari also rebuts the assertion that Islamic banks face more risks than their conventional counterparts, since dealing in loans – as conventional banks do – does not lead to a reduction in banking risk. Therefore, the cause of a higher level of risk for Islamic banks is the result of relying on non-PLS modes of financing, such as *murabaha*. The reason for this situation is that financial assets generated from *murabaha* assets resemble those which are generated by conventional bank loans.

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<sup>134</sup> Chapra, op. cit., p.108.

<sup>135</sup> Sundararajan and Errico, op. cit., p.4.

<sup>136</sup> Ibid.



This led those dealing with Islamic banks to compare the burden of financing through *murabaha* with the burden arising from bank loans, because each in the end is a debt. This, in turn, led to the conclusion that the operations of Islamic banks carry a heavier burden than bank loans.<sup>137</sup>

As has been stressed by Chapra, the non-PLS modes of financing, such as *mu'ajjal* and *murabaha*,<sup>138</sup> could degenerate into purely financing agreements with an agreed profit margin and thus would be no more than a mask for interest.<sup>139</sup>

Iqbal and Mirakhor assert that the systems under which the assets and liabilities of banks are acquired on a PLS basis have created important implications:

First, the real values of assets and liabilities would be equal at all points in time. In addition, the prospect of instantaneous equilibrium between the assets side of the banking system – driven mainly by the real sector of the economy – and the liability side means that there must necessarily be a close and direct relationship between investment and deposits yields. Also, since the return to liabilities of the banking system is a direct function of the return to the asset portfolio of the system, and since assets are created in response to investment opportunities in the real sector of the economy, it is the real sector that determines the rate of return to the financial sector rather than the reverse. Furthermore, in an Islamic financial system, the adjustment to shocks leading to banking crises and disruptions in the country's payment mechanism is faster than in the conventional system. There will also be no disruption in the intermediation process of the banking system, nor is there any reason to believe that the savings and investment process will be impaired. Indeed, savings and investment need not decrease, and if the rules of the Shari'a regarding contracts – including full disclosure requirements – are observed, both will increase.<sup>140</sup>

From these views, it seems that, theoretically, an Islamic bank is better placed than a conventional bank to absorb external shocks such as economic turmoil. If the enterprise or project makes a vast amount of profit, the bank expects to receive a high return. Upon receiving a proportionately huge share of the profit from the business, the bank compensates the depositors or investors with a high profit rate, which might be much higher than the return indicated earlier. The returns to the bank and

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<sup>137</sup> El-Gari, op. cit., p.21.

<sup>138</sup> In Malaysia, Islamic banks use the term *al-bai' bithaman ajil* instead of *murabaha* and *mu'ajjal*.

<sup>139</sup> Chapra, op. cit., p.169.

<sup>140</sup> Iqbal and Mirakhor, op. cit., pp.391–392.



investors are closely related to the performance of the business. As a result, the profit-sharing arrangement could bring prosperity in a balanced manner, thus avoiding the inequalities in the distribution of income, which exist all over the world today.

# CHAPTER FIVE

## **5 Management of Risk in Islamic Banking in Malaysia**

### **5.1 An Overview**

In Chapter 4, the concept of risk from the Islamic and conventional perspectives has been examined in detail. Risk in Islamic and conventional banking has also been carefully compared to discover why the principles of profit/loss-sharing modes of financing have been neglected or “overlooked” by Islamic banks.

In Chapter 5, the results of interviews with officers at Bank Islam (M) Berhad are analysed and briefly discussed to examine the reasons for the slow implementation of profit/loss-sharing modes of financing in Malaysia, especially in BIMB itself. Islamic banking in Malaysia faces serious challenges, for financial operations in the country are organized according to a dual system. In addition, this chapter discusses the huge losses incurred by BIMB in 2005, with particular reference to the management of risk by this bank. Chapter 4 has emphasized that the supervision and governance of Islamic banking are essential in managing risk. In Chapter 3 (section 3.3.4), the supervision and regulation of the banking system in general under Bank Negara Malaysia (BNM) has already been discussed in detail. However, in Chapter 5, the discussion is taken to the next stage, namely, the steps that have been taken so far by BNM in managing risk in Islamic financial institutions in Malaysia.

### **5.2 Profit/Loss-Sharing Modes of Financing vs Non-Profit/Loss-Sharing Modes of Financing**

Chapter 4 has described how some of the risks faced by Islamic banks differ from those faced by conventional banks. It has been found that even where the type of risk is the same in both banking systems, the level in Islamic banking is higher, owing to

the requirement for the latter to comply with the Shari'a.<sup>1</sup> This section discusses briefly the over-reliance of Islamic banks in Malaysia on non-profit/loss-sharing modes of financing, specifically *al- bai' bithaman ajil* (BBA)<sup>2</sup>, and the effects of the financial crisis in 1997 on Islamic banking. The risks of profit/loss-sharing financing have already been discussed in detail in Chapter 4. It has also been mentioned in Chapter 3 that Islamic banks are reluctant to implement profit/loss-sharing financing because they consider the risks associated with it to be too high. However, some scholars, such as El-Gari (section 4.5.3), point out that the cause of the higher level of risk for Islamic banks is the result of relying on non-PLS modes of financing. In addition, some scholars accept that the use of PLS financing means that Islamic banks are better placed than conventional banks to absorb external shock such as economic turmoil.<sup>3</sup> Therefore, in this section it is particularly important to analyse the reasons for the slow implementation of *mudharabah* and *musyarakah* financing in Malaysia by examining the situation from the point of view of the officers at BIMB.

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<sup>1</sup> In Chapter 4, it has been stated that there are two categories of risks in Islamic banking: (1) risks that are commonly faced by conventional banks, such as credit risk, market risk, operational risk, and so on; and (2) risks that stem from the profit/loss-sharing features of Islamic banking. Although Islamic banks share the same risks in the first category as their conventional counterparts, the level of some of these risks is different. For example, the conventional banks can control the interest rate, exchange rate, commodity and equity price risks by using futures, forwards, options and swap contracts. In Islamic banking, however, it has not been possible to design Shari'a-compatible substitutes for the conventional risk management instruments, since there has been no agreement so far by the *fuqaha* on the permissibility of these instruments.

<sup>2</sup> It has been discussed in Chapter 3 that *al- bai' bithaman ajil* (BBA) is a contract of financing sales by deferred instalments. It is one of the most popular financial instruments in the Malaysian Islamic banking system. In the Middle East, it is also known as *murabahah*.

<sup>3</sup> See, section 4.5.3.

### 5.2.1 Over-reliance on Non-Profit/Loss-Sharing Modes of Financing: Impact on Islamic Banks

During the Asian financial crisis in 1997, which began in Thailand and hit Malaysia in July of that year, a policy of high interest rates was pursued to defend the Malaysia Ringgit. As a result, Islamic banking was seriously affected, owing to its structure.<sup>4</sup>

In its *Annual Report* of 1997, BIMB noted the following:

The tight liquidity situation has put pressure on the operations of Islamic banking. The current turmoil has revealed a structural weakness in Islamic banking operations, particularly under a volatile economic environment. In Malaysia, 90 per cent of Islamic financing is negotiated on fixed-rate terms such as *al-murabahah*, *al-bai' bithaman ajil* and *ijarah thumma al-bai'*. Conventional banking has the flexibility to adjust upwards the interest rate on borrowing accordingly to reflect the higher cost of funds. Comparatively, the return for financing under Islamic banking would decline under this environment and contribute to lower deposit rates to depositors. In essence, Islamic banking could not react swiftly under the current interest rates environment due to the absence of a floating-rate option. Thus the lagging factor resulted in a mismatch, whereby the financing–deposit ratio registered an increase from 84.6 per cent as at end 1996 to 108.6 percent as at end 1997. To accommodate the shortfall, Islamic banking institutions had to resort to *mudharabah* placements, which amounted to RM2.6 billion as at end 1997.<sup>5</sup>

In a study of *al-bai' bithaman ajil* (BBA), Rosly says that the rise in interest rates has the following consequences for Islamic banks:

In general, as interest rates rise, the demand for BBA is expected to increase, since the existing BBA profit rate will not change. As the volume of BBA increases, Islamic banks are expected to make more profits as higher profit rates can then be attached to the new BBAs. However, the margins of the existing BBAs will be severely affected if the bank decides to increase the *hibah* and dividend on *al-wadiah* and *al-mudharabah* investment deposits in order to attract more deposits.<sup>6</sup> In the dual-banking system, where the sizes of assets and deposits of conventional banks are much bigger than Islamic banks, changes in the market interest rates are expected to shift the supply of deposits towards alternative facilities that award higher returns. For example, when interest rates are rising, more customers will opt for BBA financing, since it is not a floating

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<sup>4</sup> Bank Negara Malaysia, *Annual Report*, quoted in Saiful Azhar Rosly, “*Al-bai' bithaman ajil* Financing: Impacts on Islamic Banking Performance”, *Thunderbird International Business Review*, vol.41, no.4/5 (1999), p.475. The empirical evidence showed that the profits of BIMB declined during the period of rising interest rates (1997), whereas the interest margins of the conventional banks increased (*ibid.*, p.477).

<sup>5</sup> *Ibid.*

<sup>6</sup> *Ibid.*



rate asset. However, the profits on existing BBA contracts cannot be adjusted upward, despite the desire of Islamic banks to compete with conventional banks, whose interest rates on loans are not fixed. While maintaining their profit margins, conventional banks will increase interest rates on deposits. To regain competitiveness, Islamic banks may also choose to increase the *hibah* and dividends, but this strategy will lead to diminishing profit margins.<sup>7</sup>

A fall in market interest rates means lower rates on loans. With regard to their assets, Islamic banks fail to react quickly to market volatility and make loans cheaper than BBAs, causing the demand for BBAs to fall. Rosly explains further:

The BBA facility simply cannot adjust the contractual selling price downwards, as this will violate the sale agreement, in which the bank is required to quote only one selling price. Consequently, the BBA will be more expensive than loans.<sup>8</sup>

The structural weakness was noted by BNM in its *Annual Report* in 1997, and it asked Islamic banks to create a floating rate product that would react quickly to the sudden changes in a volatile economy. However, until 2005, BIMB never declared any losses.<sup>9</sup> Eight years later, for the financial year ended in 2005, BIMB declared a

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<sup>7</sup> Ibid., p.472. As a fixed-rate asset, BBA contractual prices cannot change to reflect a tight credit market; thus they will be cheaper than loans. In a Gap analysis, overdependence on deferred sale financing would mean that most assets would not be sensitive to changes in market interest rates, since all Islamic liabilities are interest sensitive (i.e., *hibah* and dividend rates can be altered according to prevailing competitive market deposit rates) (ibid., p.469).

<sup>8</sup> Ibid., p.473. According to the author, under the dual banking system in Malaysia, the non-Muslim customers are expected to gain more compared with Muslim customers, for the demand for financing and placement of deposits shifts from one system to another, depending on which provides the greatest benefit.

<sup>9</sup> Bank Negara Malaysia, *Annual Report* (Kuala Lumpur: Bank Negara Malaysia, 1997), pp.141–142. An attempt to strengthen the Malaysian banking industry after the Asian financial crisis resulted in the mergers of financial institutions into ten in 2000 and nine in 2006. However, BIMB did not participate in the mergers because, at that time, it was the only Islamic bank in the country. During the Asian financial crisis, the former Prime Minister, Dr Mahathir Mohamad, his Finance Ministry officials and Bank Negara spent much time, effort and resources in restructuring the Malaysia financial system and corporate debt. This included the adoption of the Financial Sector Masterplan (covering conventional banking, Islamic banking, capital markets, insurance, and *takaful*). The special purpose vehicles Danaharta and Danamodal were also established, the former to be responsible for the restructuring of the financial sector debt, and the latter the restructuring of corporate debt. The merger plan was subject to criticism. See, for example, Thomas Fuller, “Financial Restructuring to be Overhauled: Banking Merger Plan Collapses in Malaysia”, in

net loss of RM507.8 million, compared with a profit of RM98.3 million for the financial year ended in 2004.<sup>10</sup> The loss was due to a higher provisioning for non-performing financing (NPF) of RM648 million, following the increase in the NPF level, mainly attributed to Bank Islam Labuan Offshore Branch (BILOB).<sup>11</sup> It is reported that 35 per cent of the NPF came from BILOB, 30 per cent from the Bank's commercial unit and the balance from consumer and corporate clients.<sup>12</sup> It was confirmed by Dato' Noorazman Aziz<sup>13</sup> that this longstanding problem of NPF had accumulated since the Asian financial crisis in 1997.<sup>14</sup> Noorazman Aziz said that the NPF of BILOB was due to weak client-originated credit structuring, inadequate

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*International Herald Tribune*, 21 October 1999. The criticisms included the following: "The plan was perceived as a combination of greed and desire to control the financial system." "The government is feeling intense pressure and lobbying before the election." It was also stated that opposition groups had criticized the merger for being politically motivated and for concentrating control over the banking system in the hands of banks with strong links to the government. Indeed, many analysts said that the plan was flawed from a purely financial point of view. For example, Mohammed Ariff, Executive Director of the Malaysian Institute of Economics Research, stated: "The idea was to strengthen the whole system, but somewhere along the line, they missed the point. They thought, the bigger the better. That is where things went wrong. They wanted to create banks that were too big to fail. But that is the wrong assumption, because if a big bank fails, it causes big waves. If a small bank fails, it only causes ripples" (Fuller, *ibid.*). From the government's point of view, the former Finance Minister, Daim Zainuddin, said that banks needed to be stronger because the government was tired of bailing them out. He added: "We cannot afford to save banks every 10 years or so. That is why the mergers are unavoidable. The recent crisis has exposed the vulnerabilities of a fragmented banking system." Bank Negara officials said: "It is important that the present window of stability be used to the fullest by bringing about a major consolidation of the banking system." See, Anil Netto, "Rushed Bank Mergers Cast Shadow on Malaysian Recovery" *Asia Times Online*, 8 September 1999, [www.atimes.com](http://www.atimes.com). Cited 8 July 2007.

<sup>10</sup> Bank Islam (M) Berhad, *Annual Report* (Kuala Lumpur, Bank Islam (M) Berhad, 2005), p.4.

<sup>11</sup> *Ibid.*

<sup>12</sup> Anil Netto, "Islamic Bank's Woes Highlight Problems", *Asia Times Online*, 5 November 2005, [www.atimes.com](http://www.atimes.com). Cited 10 July 2007.

<sup>13</sup> Dato' Noorazman A. Aziz was appointed as the new Chief Executive Officer of the new management team on 1 April 2005. He left BIMB Berhad in June 2006 to be the Group Managing Director of BIMB Holdings, the parent group of BIMB. His successor in July 2006 was Dato' Zukri Samat, the former Managing Director of Danaharta and Khazanah Nasional.

<sup>14</sup> "Bank Islam Suffers RM500m Loss", *New Straits Times*, 7 November 2005, [www.nst.com.my](http://www.nst.com.my). Cited 15 November 2005.

account monitoring and ineffective recognition. He also confirmed that most of the bad debt comprised loans made to companies in Sarajevo and South Africa and some of the borrower firms no longer existed.<sup>15</sup>

The news of the huge losses on BIMB put the spotlight on Malaysia's banking system, particularly Islamic banking. It raised the question of dereliction of duty on the part of the government and the regulator. There is further discussion of the BIMB losses, the first in its history, in section 5.3.

### **5.2.2 Interview Findings**

BIMB was chosen as a case study to find the reasons for the slow implementation of profit/loss-sharing modes of financing because it was the first Islamic bank in Malaysia. As a pioneer in the market, its example will be followed by other banks. In comparison with other Islamic banks and Islamic "windows" banks in Malaysia, BIMB had already been established ten years earlier, which indicates the Islamic banks are more stable in resources such as market knowledge and expertise.<sup>16</sup> However, the use of the profit/loss-sharing modes of financing remains low.<sup>17</sup> These factors seemed to justify the choice of BIMB for this interview.

The fieldwork for these interviews was carried out in April 2005. Ten members of staff were interviewed, seven from the Risk Management Department at BIMB's head office, and three from the state office. They consisted of senior managers, managers and officers. The data were then validated by interviews with the Chief

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<sup>15</sup> Ibid.

<sup>16</sup> Informal discussion with a few employees of other commercial banks at the Seminar on Risk Management in Islamic Financial Services, organized by the Centre for Research and Training (CERT) at the Istana Hotel, Kuala Lumpur, Malaysia, 26–27 April 2005.

<sup>17</sup> See, Chapter 3 for a statistical analysis of the profit/loss-sharing modes of financing from 1983 to 2005.

Executive Officer, Mr Najib Shaharuddin<sup>18</sup> of the Bank Islam Labuan Offshore Branch (BILOB). The questionnaire concentrated on the factors affecting the Bank's ability to offer financing products under the profit/loss-sharing modes financing. The outcome of the interviews is described below.

#### **5.2.2.1 Factors Affecting the Availability of Financing Products under *Mudarabah* and *Musyarakah* Contracts**

The interviews with the employees were analysed manually and the factors arranged as shown in the discussion below. It should be noted that the factors are not in a particular order, that is, they are not arranged in order of importance according to the employees participating in the questionnaire. In the discussion, the respondents are identified as Mr A, Mr N, Mr X and so on, as appropriate. The interviews were conducted in the Malay language (Bahasa Malaysia).

#### **STAFF COMPETENCY AND EFFICIENCY**

Most of the respondents said that BIMB was faced with the problem of human capital, which was preventing it from offering the financing products under the profit/loss-sharing system. For example, under a *musyarakah* contract, the bank in its role of financier or partner is allowed to have a say in the management of the project, to monitor its progress and follow up its achievements. In practice, however, it is very difficult to monitor and control *musyarakah* financing, for this type of contract is open to fraud, fund leakage or the overstatement of costs, all of which are hard to prove. It should be noted that it is even more difficult for a bank to evaluate the investment viability of a project if the resources, such as human capital, monetary capital, an appropriate system, etc., are lacking. In *mudharabah* financing, although

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<sup>18</sup> He left the Bank in the middle of 2005.

the bank has no say in the management of a project, nevertheless, it is crucial that it monitors its progress.

The bank must also have access at all times to the borrower's account to ensure that the business is conducted correctly and efficiently. Since the return to the bank is a proportion of the total profit, which, in turn, is linked to the return to the depositors or investors, the effect of losses could be disastrous. Therefore, the bank employees monitoring the project to check the validity of invoices and claims and the quality and quantity of goods etc. supplied by a third party must have the appropriate competency and expertise. There are other problems, which are shared by the conventional banks too, such as dishonesty, irresponsibility and other negative behaviour by the bank's employees themselves. In addition, employees come from a range of educational backgrounds. The bank must also have access at all times to the borrower's account to ensure that the business is conducted correctly and efficiently. Since the return to the bank is a proportion of the total profit, which, in turn, is linked to the return to the depositors or investors, the effect of losses could be disastrous. Therefore, the bank employees monitoring the project to check the validity of invoices and claims and the quality and quantity of goods etc. supplied by a third party must have the appropriate competency and expertise. There are other problems, which are shared by the conventional banks too, such as dishonesty, irresponsibility and other negative behaviour by the bank's employees themselves. In addition, employees come from a range of educational backgrounds and most of them do not have a sufficient grounding in the Shari'a before joining BIMB. An empirical study conducted in the northern states of Malaysia (Kedah, Perlis and Pulau Pinang) also revealed that employees at both Islamic banks and Islamic "windows" banks had not received any education relevant



to Islamic banking. They stated that they did not have a sufficient knowledge of the Shari'a and Islamic banking.<sup>19</sup>

#### MORAL HAZARD

Moral hazard<sup>20</sup> is a critical factor that seriously limits BIMB's ability to offer profit/loss-sharing modes of financing. That is especially true of *mudharabah* financing, in which the bank has no means of monitoring and controlling a project. This could encourage a customer to use the fund too freely or even divert the business or project from the main purpose of the contract. Financing based on profit/loss-sharing principles depends heavily on the honesty of the entrepreneur as well as the efficiency of the bank to assess and evaluate his/her character, capability and credibility. This is not an easy task, for it affects the returns to the depositors.<sup>21</sup>

One of the respondents, Mr X, said that the profit/loss-sharing modes of financing, especially *mudharabah*, were probably more suited to an earlier way of life, when members of a community were more closely tied to one another. Thus, they had a good knowledge of one another's character and capabilities and knew whom they could trust. Nowadays, however, life is very different, for modernization has caused the disintegration of community relationships. Furthermore, the advances in modern technology have contributed to fraud and negligence in banking, and

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<sup>19</sup> Zairani Zainol, Rohaya Shaari, and Hafizi Muhammad Ali, "A Comparative Analysis on Bankers' Perceptions on Islamic Banking". Paper presented at the National Seminar on Islamic Banking and Finance 2006 (IBAF 2006), Kolej Universiti Islam Malaysia (KUIM), Kuala Lumpur, 30–31 August, 2006.

<sup>20</sup> The notion of moral hazard is commonly used in financial regulation. It refers to policies that may encourage reckless behaviour (see Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh, UK: Edinburgh University Press, 2000), p.155).

<sup>21</sup> To avoid serious misuse of investors's funds and to ensure that the funds are well protected, BIMB Holdings – Bank Islam (M) Berhad, also one of its subsidiaries – established BIMB Musyarakah Satu Sdn Bhd and BIMB Musyarakah Dua Sdn Bhd as a subsidiary, whose main activities are a venture capital company and an investment company.

therefore, it is almost impossible to adopt systems that are based on trust and do not require any collateral. Most of the respondents agreed that it was difficult and, indeed, almost impossible, to find trustworthy entities today compared with the era of Prophet Muhammad (pbuh). Mr A also pointed out that in the literature of Islamic economics, the Muslim economists assume the ideal situation, where the entrepreneur is a good Muslim and the transaction under the profit/loss-sharing system will work smoothly without any difficulty.

Warde also reveals that for many people, religious fervour was a reason to work for an Islamic bank or to conduct business with it. Nevertheless, "it was soon discovered that religion could be a double-edged sword."<sup>22</sup> He states that in the Qur'an, there are numerous references to hypocrites. Since time immemorial, swindlers have used the cover of religion as a means of rapid enrichment. He quotes a saying attributed to L. Ron Hubbard, founder of the Church of Scientology: "If you want to get rich, start a religion."<sup>23</sup>

Satkunasingan and Shanmugam have pointed out that the existence of corruption and evidence of the failure to enforce good governance requirements are among the factors discouraging Islamic banks from adopting modes of financing that offer greater opportunity for corporate mismanagement and abuse. Nevertheless, during the interviews, the respondents did not reveal directly that the extra susceptibility of BIMB to these problems was due to past and current political interference and manipulation in the corporations and the banking industry.<sup>24</sup>

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<sup>22</sup> Warde, op. cit., p.155.

<sup>23</sup> Ibid.

<sup>24</sup> Elsa Satkunasingan and Bala Shanmugam, "Disclosure and Governance of Islamic Banks: A Case Study of Malaysia", *Journal of International Banking Regulation*, vol.6, no.1 (2004), p.74.

Satkunasingam and Shanmugam point out that politics in Malaysia during the 1990s heralded close relations between business people and politicians. This was later known as “cronyism”, in which evidence showed that politicians were engaged in awarding contracts to business people who returned favours.<sup>25</sup> It was also believed that in some situations, “politicians or their family members owned businesses and obtained government contracts easily and this was part and parcel of patronage politics practiced within political parties in Malaysia very soon after independence.”<sup>26</sup> In addition, “political supporters of the ruling party were rewarded with directorships on the boards of such state corporations, despite their lack of experience and, at times, lack of integrity.”<sup>27</sup> The Asian financial crisis in 1997 was believed to have been caused by the lack of transparency and accountability of Asian banks and it brought about the incorporation of some of the principles recommended by the Cadbury and Hampel Committee into the Malaysian Code on Corporate Governance 2000.<sup>28</sup>

Satkunasingam and Shanmugam assert that one of the aims of the Code is to encourage companies to have independent non-executive directors on the board to ensure good corporate governance. However, the Code has not addressed how to protect the independence of the board from political influence. Satkunasingam and Shanmugam also believe that the banking sector was “not independent of politicians who interfered with the central banks’ recommendations of sound financial practices

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In 1981, BMF (Bank Bumiputra Malaysia Finance Ltd) as a subsidiary to Bank Bumiputra Malaysia Berhad lost RM2.5 billion to three property developers in Hong Kong. The managers of BMF were found to have had a friendly relationship with the developers and the loans were granted, despite the lack of security and correct documentation.

<sup>25</sup> Ibid.

<sup>26</sup> Ibid.

<sup>27</sup> Ibid., p.77.

<sup>28</sup> Ibid.

to serve their political interests or those of their cronies.”<sup>29</sup> The customers placing *mudharabah* deposits in Islamic banks have to bear only the risks normally attached to these accounts, not the risks imposed by corrupt politicians. Therefore, the authors suggest that Islamic banks should not operate according to *mudharabah* principles, but instead in a conventional manner by requesting collateral from the borrowers who wish to obtain loans from them. However, it is a question of whether the Malaysian Code of Corporate Governance can be fully implemented, for it is currently seen as an example of “law in books”, rather than “law in action”, although certain parts of the Code have been incorporated into the listing requirements of the Kuala Lumpur Stock Exchange.<sup>30</sup>

“Cronyism” is not a new problem in Malaysia. The former prime minister, Tun Dr Mahathir Mohamed, had an altercation with his successor, Dato’ Seri Abdullah Badawi,<sup>31</sup> over this question. The first row erupted in April 2006, when Abdullah cancelled plans to build what was to have been the Malaysian half of a new bridge between Malaysia and Singapore. This new link was one of several “mega-projects” approved when Mahathir was in power. Abdullah’s action gave Mahathir the opportunity to launch a stream of allegations against him. Mahathir’s allegations included the mismanagement of Proton (the national motor manufacturers), and the growing influence of Abdullah’s relations in obtaining government contracts and deals.<sup>32</sup> At the time of writing, the conflict between the present and former prime ministers of Malaysia remains unresolved.

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<sup>29</sup> Ibid.

<sup>30</sup> Ibid.

<sup>31</sup> Abdullah was made deputy prime minister after Mahathir dismissed his predecessor, Anwar Ibrahim, in 1998.

<sup>32</sup> Romen Bose, “Malaysian Leaderships Spat Steps up a Gear”, Monday, 30 October 2006 [www.aljazeera.net](http://www.aljazeera.net), cited 31 October 2006

In addition, corruption is one of the factors contributing to the low level of participation of Islamic banks in the profit/loss-sharing modes of financing.<sup>33</sup> A few of the respondents admitted that this was true of BIMB, for corruption could seriously harm the system and the Bank had to protect its depositors. The evidence of the level of corruption in Malaysia is reflected in the statistics compiled by Transparency International, a non-governmental organization founded in Berlin in 1993.<sup>34</sup>

#### MALAYSIA AS A MULTIRACIAL COUNTRY

Most of the respondents contended that Malaysia was a multiracial country where different faiths were followed by the various ethnic groups. Therefore, it would be difficult to adopt the profit/loss-sharing system wholesale. In Malaysia, there are large numbers of non-Muslims, whose beliefs are very different from those of

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<sup>33</sup> Satkunasingan and Shanmugam, op. cit., p. 79.

<sup>34</sup> *Transparency International Corruption Perceptions Index*, [www.transparency.org](http://www.transparency.org). This is a composite survey of the perceptions of business people and country analysts, both resident and non-resident. The survey is widely used as a reference by investors and therefore, it has a marked effect on a country's economic and political interests. According to Hamden Ramli, "Indeks Rasuah: Kedudukan Malaysia Merosot Ke Tangga 44", *Utusan Malaysia*, 7 November 2006, [www.utusan.com.my](http://www.utusan.com.my) (cited 8 November 2006). Malaysia in 2006 is ranked at 44, having fallen from its 39<sup>th</sup> position of 163 countries in 2005. The ranking has revealed that the Corruption Perception Index for Malaysia has slipped from 5.1 on a scale of 1–10 (where 10 denotes clean and 1 extremely corrupt) in 2005 to 5.0 in 2006. At a Press conference held in Kuala Lumpur on 6 November 2006, Datuk Zakaria Jaafar, the Deputy Director-General of the Anti-Corruption Academy (ACA) announced the result of the Corruption Perceptions Index. He pointed out that the rise in the number of complaints about corruption was a good sign of public confidence in the ACA. At the World Ethics and Transparency inaugural in Kuala Lumpur, a Minister in the Prime Minister's Department, Tan Sri Bernard Giluk Dompok, said: "There were certain weaknesses in the study methodology as Malaysia's CPI score was based on a composite of corruption indicators from nine institutes, while some other countries scores were based on fewer studies. Nevertheless, these problems with their perception and image will only spur us to work harder to address the perceived lag between the formulation of new policies and the actual implementation of these policies on the ground." He added that the concept of transparency had become irrevocably linked to competitiveness, thus giving reason for the current administration to highlight transparency, ethics and accountability as cornerstones of improving the nation. See, "Malaysia Trying to Attain Greater Transparency", [www.mstar.com.my](http://www.mstar.com.my). Cited 12 February 2007.



Muslims. Since there is a wide choice of banks and products, non-Muslim customers prefer to put their hard-earned savings in a low-risk investment, for they have the assurance that they will receive a fixed amount of money. In their view, this is preferable to sharing the risk, despite the possibility that returns on profit/loss-sharing accounts would be higher, because these accounts also carry the risk of losing part or all of the principal. Non-Muslim customers are not influenced by religion or the wish to avoid *riba*, and therefore, they can choose the bank that gives them excellent service, high return, etc. It cannot be denied, however, that the Islamic banks have a small number of non-Muslim customers, who state that they are impressed with the system operated by these banks.

The motives of Muslim customers are still open to question. As pointed out by Warde, nowadays, it is very difficult to measure accurately the relative importance of the two reasons – one religious and the other financial/commercial – why people choose to deal with Islamic financial institutions.<sup>35</sup> In his view, the motives for participation in any human endeavour are complex. In addition, the surveys conducted so far can be misleading, for respondents are always likely to exaggerate the role of religion. Warde further emphasizes that although there are innumerable marketing tools available to segment markets and analyse customers' needs and characteristics, the religious dimension remains indefinable.

It was stated by a few respondents that if BIMB were to survive and have an advantage over its competitors, it would need to attract as many depositors as possible. It should be noted that another aspect of Islamic banking was highlighted, namely, the lack of marketing effort by the Islamic banks themselves. Most of the

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<sup>35</sup> Warde, op. cit., p.159.

respondents agreed that the marketing efforts by BIMB were not intensive, compared with their competitors from Islamic “windows” banks and conventional banks. In BIMB (when these interviews were conducted), the marketing efforts were handled by the Business Development Manager at the state office.<sup>36</sup>

#### CONCENTRATION OF OTHER TYPES OF PRODUCTS AND SERVICES

BIMB offers many types of financing and deposit/investment products and services to its customers. It was also pointed out by a few respondents that a concentration on other types of financing products contributed to a low use of profit/loss-sharing modes of financing. Many of the respondents said that the reason was that the Bank’s experience and expertise were in products such as *al-bai’ bithaman ajil*, *murabahah*, etc. However, one of the respondents, Mr N, said that BIMB should concentrate on a particular market or specialization. He added that currently, BIMB did not focus on a particular market, whereas it could make full use of its resources to exploit the market where it had the greatest capability.

The question of capital was raised by some of the respondents as a factor restricting BIMB’s use of the profit/loss-sharing modes of financing. Mr N said that the greater concentration of capital in other types of financing meant that an insufficient amount was available to support profit/loss-sharing modes of financing.

#### LEGISLATION

The question of legislation was raised by one of the respondents, Mr A. He gave the example of a *musyarakah* joint venture, in which capital contributed by the partners belonged to the partnership. Therefore, the title to the capital should be in the name of the partnership to indicate its common ownership. However, Section 66 of the

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<sup>36</sup> At that time, the division of the regional office was based on the state office.

Banking and Financial Institutions Act 1989 (BAFIA) imposes restrictions on the holding of shares in other corporations and the holding of immovable property other than that which is necessary for conducting on its business, except where it is taken by way of security for loans. The Central Bank may approve the holding of shares in selected corporations. In addition, there is no civil law specifically covering profit/loss-sharing modes of financing to protect the bank from any losses resulting from fraud or default by the other party. Bakar also agrees that one problem of equity financing in the Islamic banking system in Malaysia is the structural issues:

Structural issues are issues related to the existing bank regulations, tax structure and other regulatory issues. Even though the Islamic Banking Act 1983 gives more flexibility to Islamic banks in terms of financing products, other aspects are very similar to conventional banks, flexibility is not elaborated and in practice, the Interest-Free Banking Scheme (SPTF) guidelines issued by Bank Negara also do not clearly provide the guidelines for *mudharabah* and *musyarakah* financing. Also, there is a limit of a 10% shareholding by a bank in a particular company under the Banking and Financial Institutions Act 1989 (Banking and Financial Institutions Act 1989 (Act 372), Section 46 (1) (a). This amount is so insignificant that the entrepreneur has to approach several investors to take off a new venture. Most banks are still unsure on what they can or cannot do, whether *mudharabah* and *musharakah* financing will affect their capital adequacy ratio, what are the relevant accounting treatment and the like. Confirmation on any issues requires clarification from Bank Negara or other regulatory agencies and this could delay a financing exercise. This eventually could lead to banks taking the easy way out and resorting to other more convenient tools of financing such as *murabahah* and *bai 'bithaman ajil*.<sup>37</sup>

According to Bakar, BNM has its reason for limiting the shareholding to 10 per cent. The aim is to avoid the formation of a conglomerate of the banks and a giant company, which might create a monopoly. However, since BIMB is governed by the Islamic Banking Act 1983, it has the freedom to exceed the limit of 10 per cent shareholding in any particular company.<sup>38</sup>

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<sup>37</sup> Mohd Daud Bakar, "Contracts in Islamic Commercial and Their Application in Modern Islamic Financial Systems". Teaching material used at the Centre for Research and Training, Kuala Lumpur, 2002, p.32.

<sup>38</sup> Ibid.

## 5.3 Product Innovation and Development

In Malaysia, product innovation and development are very important in Islamic banking, owing to its structure and the market itself. The aim here is to protect the parties concerned, that is, both the customers and the banks. Therefore, the Shari'a experts and practitioners must be prepared to meet the challenges for innovation, to construct and develop products that are efficient, competitive and practical from the perspective of modern banking. It should be noted that the products must be available at a fair price. This section examines the view put forward by el-Gamal concerning Islamic financial products.

### 5.3.1 El-Gamal's Views

El-Gamal looks at the reasons for the price difference between Islamic and conventional financial products:

The term "Islamic finance" brings to mind an analogy to the concept of a "Christian shoe," rather than to good products that are fairly priced. Indeed, we shall see that the primary emphasis in Islamic finance is not on efficiency and fair pricing. Rather, the emphasis is on contract mechanics and certification of Islamicity by the "Shari'a Supervisory Board." To the extent that "Islamic" financial products also cost more than the conventional products they seek to replace – partly because of relative inefficiency, and partly to cover otherwise unnecessary jurist and lawyer fees – one may make partial analogies between those certifications and the European pre-Reformation practice of selling indulgence certificates.<sup>39</sup>

El-Gamal asserts that an analysis of the products and services currently offered under an Islamic financial system shows that innovation has almost caught up with

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<sup>39</sup> Mahmoud A. el-Gamal, *Islamic Finance: Law, Economics, and Practice* (New York: Cambridge University Press, 2006), p.1. Regarding the price difference between Islamic and conventional financial products, Mr M from Bank B says: "There are many factors determining product pricing. Among others are an unfriendly legal and tax regime, and a risk premium imposed on new ideas or product invention. All these occur during the stages of research and development and initial production, which is what happened to Islamic banking in the late 1980s. Now, if you look at the mature debt capital market in Malaysia, especially the Islamic *sukuk*/bond of the same rating, it is always cheaper than its conventional counterpart. Among the reasons for this are a friendly legal and tax regime, a lower product risk premium, and high Islamic money liquidity."

the conventional sector.<sup>40</sup> He says that jurists are likely to continue offering innovations that will eventually lead to a convergence of Islamic financial practice with its conventional counterpart. This situation will, in turn, cause disappointment among both potential new customers and existing customers of the Islamic financial institutions, for the differentiation between an Islamic product and its conventional counterpart will appear increasingly contrived.<sup>41</sup> He criticizes the functions of the bankers, lawyers and jurists on the Shari'a Board concerning product development:

Interactive discussions between bankers, lawyers, and jurists commonly start with an existing conventional product for which no Islamic alternatives are available. The three groups then engage in a process of financial reengineering of the product, replacing its various conventional components that are deemed un-Islamic with others that can be presented to the public and defended as Islamic. In the later stage of product development and marketing, the vehicle of choice has been modification and adoption of pre-modern nominate financial contract names. Coverage of the pre-modern contracts in classical jurisprudence texts thus makes the new products identifiable as Islamic. To maintain credibility, industry practitioners insist on using Arabic names of contracts, for instance, "*ijara*" instead of equivalent "*lease*," or "*murabaha*" instead of the equivalent "*cost-plus sale*."<sup>42</sup>

El-Gamal proposes refocusing Islamic finance on its substance instead of its form by abandoning the "paradigm" of the "Islamization" of every financial practice.<sup>43</sup> The brand name of Islamic finance would also require reorienting to emphasize community banking, microfinance and socially responsible investment

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<sup>40</sup> Ibid., p.182.

<sup>41</sup> Ibid., p.183.

<sup>42</sup> Ibid., pp.11–12.

<sup>43</sup> It is interesting to note that during the interview with Mr W, a banker from Bank C in Malaysia gave his opinion that the Islamic financial products were the result of the "Islamization" of conventional products. It means that the development of Islamic financial products has been based on conventional products. Tan Sri Nor Mohamed Yakcop also pointed out: "We believe a dual system is better than a pure Islamic system. In a conventional banking system, changes are made every day and new products are developed as more research and development is done. Products get more sophisticated by the day. And if you do not have a conventional banking system, you would not know what is happening in the outside world. Because we have it in Malaysia, Islamic banks will have to learn to find products to keep the Islamic banking system on its toes when compared with the conventional banking system." See, Jagdev Singh Sidhu, "Malaysian Islamic Banking", *New Straits Times*, 29 October 2001.



and so on. In other words, he argues that “Islamic” in “Islamic Finance” should relate to the social and economic ends of financial transactions, rather than contract mechanisms with which financial ends are achieved.<sup>44</sup> He concludes that the ethical and development goals are shared widely by Muslims and non-Muslims alike. Hence, once “Islamic finance outgrows its formulaic current mode of operation, and assumes a new identity based on substantive and ethical religious tenets, it will no longer need to hide behind the “Islamic” brand name.<sup>45</sup>

### **5.3.2 Malaysian Islamic Financial Institutions: Product Innovation and Development**

Prior to 2004, Islamic banks and financial institutions in Malaysia were required to consult BNM before introducing new products and services.<sup>46</sup> The aim of this requirement was the careful control of development so as to ensure the effective assessment and management of the inherent risks and the acceptability of introducing innovations to the banking customers and the financial market as a whole. Nevertheless, BNM regarded the prior approval of all new products and services as one of the obstacles to innovation. In July 2004, BNM issued a new set of guidelines recommending that the approach of “what is not prohibited is allowed” be adopted towards new Islamic financial products. The updated procedure requiring only the simple notification of new products for specific approval was designed as an

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<sup>44</sup> El-Gamal, op. cit., pp.11–12.

<sup>45</sup> Ibid., p.191.

<sup>46</sup> Bank Negara Malaysia, *Guidelines on New Product Approval Requirements (for Islamic Banking Institutions)*, July 2003. According to BNM, a new product comprises: (1) a product or service that has never been introduced by the Islamic banking institutions/banking group; (2) an existing approved product or service that is applying a different or new combination of Shari’a concepts; (3) a combination of existing approved products or services that have already been offered by the Islamic banking institutions/banking group; or (4) the enhancement of an existing approved product or service, which has never been introduced by the Islamic banking institutions/banking group.

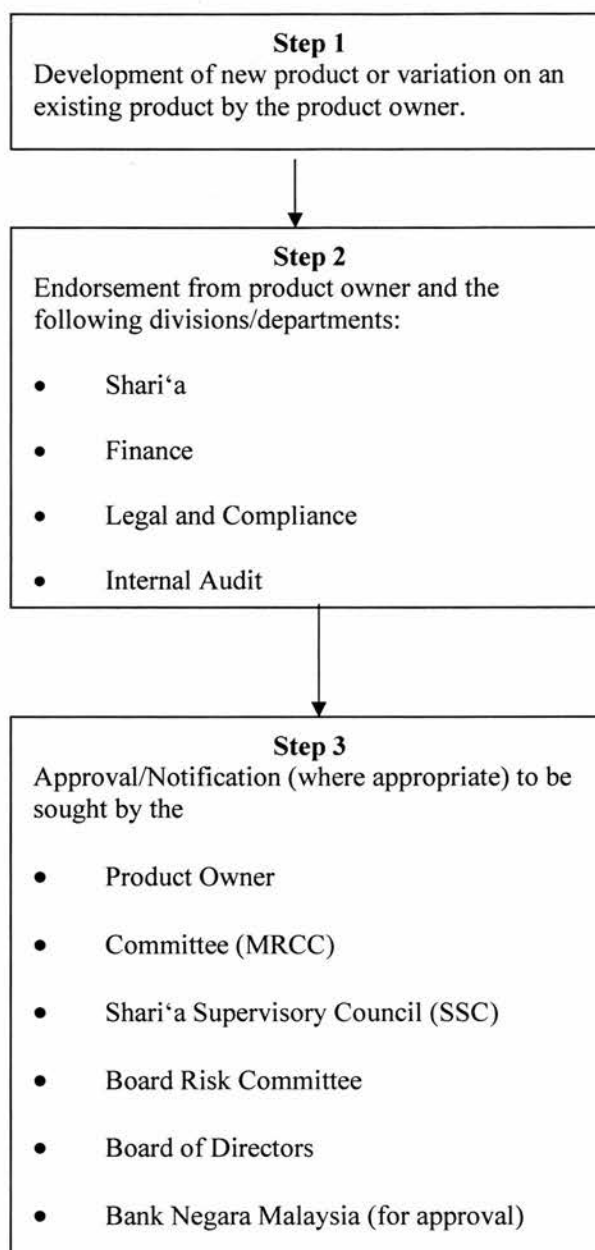
incentive to Islamic financial institutions to concentrate on further innovation.<sup>47</sup>

Figure 5.1 illustrates the three steps of the standard procedure to be followed when a new product has been developed, ending with an application to BNM – as the regulator – for approval.

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<sup>47</sup> Ibid. According to Mr. Ismail Taib (BIMB), these guidelines were implemented in August 2003.

**Figure 5.1** Standard Procedure for Product Development Approval<sup>48</sup>



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<sup>48</sup> Variation on an existing product (Step 1) includes modifications made to an existing approved product or service that is already offered by the Islamic banking institution or banking group.

In general, to approve a new product,<sup>49</sup> excluding the variation on an existing product, BNM requires Islamic financial institutions to provide the following information:

- Islamic financial institutions must describe in detail how they intend to finance the necessary skills, expertise, resources and infrastructure to enable the effective provision of the new product, for example, staff retraining.
- The product owner must describe the potential risks arising from the introduction of the new product, the method of quantifying the downside risks, as well as their mitigation and management.
- The endorsement of the relevant compliance and risk units/departments (particularly the Heads of Risk Management, Internal Audit, Compliance, Information Technology, and/or the Legal Department) concerning the ability to manage risk arising from the introduction of the new product must be provided.
- The endorsement must include the readiness of the Information Technology (IT) system to monitor and manage the new product so that operational risk is minimized.

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<sup>49</sup> Applications for approval (last item of Step 3) fall into one of the following two categories: (1) a new product that qualifies for automatic approval; or (2) a new product that does not qualify for automatic approval. The conditions for automatic approval must include the following: (1) the new product must be part of the approved business of the Islamic banking institution; (2) the new product must conform to the Shari'a concepts approved for that type of product or service; (3) if the prohibition of the new product is based on the Shari'a requirements of another country, the Islamic financial institutions need comply only with those approved in Malaysia; (4) a certain minimum level of product transparency must be made known to customers. If a new product does not qualify for automatic approval, then application must be made to BNM for specific approval. Assessment might therefore take longer, especially if the approval of the Shari'a Advisory Council is required. However, where approval of variations on an existing product is sought, the Islamic financial institutions need disclose only the relevant modifications.

- A description is also required of the security features and controls that are to be used, for example, to ensure the confidentiality, integrity and availability of information.
- The application must include the endorsement and decision of the Shari'a Committee concerning the compliance of the new product's concept and mechanism/structure with the Shari'a. The relevant *fiqh* literature and supporting evidence and reasoning must also be submitted.
- Other important information to be provided is the accounting treatment to be applied to the new product, particularly the regulatory and capital adequacy requirement.

Further examination of the guidelines indicates that financing products under the *mudharabah* and *musyarakah* systems do not qualify for automatic approval and should therefore be submitted to BNM for specific approval. This situation could be viewed as one of the impediments to innovation in this type of financing, for Islamic financial institutions might prefer to follow a safe and simple procedure to introduce new products, thus avoiding an application that might be lengthy and complicated.

However, during a further interview, Mr R, who was employed in one of the Islamic financial institutions in Malaysia, said that BNM had formed a working group (WGMMF) in 2001 to promote *mudharabah* and *musyarakah* financing. Its members comprised representatives from BNM, Islamic banks and Skim Perbankan Islam (SPI) banks. They were also supported with input from external parties such as Shari'a advisers, academics, practitioners and lawyers. In addition, the group had studied the practice of the Islamic banking system in Sudan. From these studies, according to Mr R, the group was able to highlight certain issues concerning



*mudharabah* and *musyarakah* financing in Malaysia. Under the present system of Islamic banking, one of the suggestions made by the group was the implementation of *musyarakah mutanaqisah* (diminishing *musyarakah*) financing.<sup>50</sup> However, certain changes would be required in the current laws and regulations, particularly in the Tax Act, Stamp Duty Act, accounting treatments, BAFIA, and the Partnership Act, to allow the financing models to be implemented smoothly. The group also suggested that for more specific solutions to be found, further input was needed from Shari'a advisers, lawyers and the authorities.<sup>51</sup>

## 5.4 Regulation and Supervision

The discussion throughout Chapter 4 has shown that managing risk is crucial, particularly in Islamic banking. Therefore, sound regulation and supervision are very important to support the system. According to Chapra and Khan, "The greater market

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<sup>50</sup> *Musyarakah mutanaqisah* (diminishing *musyarakah*) is said to have some important advantages over *bai' bithaman ajil* contract, for example: (1) Owing to its greater flexibility, *musyarakah mutanaqisah* is a serious alternative to a conventional mortgage. Customers have the options of floating rates and revolving facilities, as well as a combination of term and revolving facilities. (2) Should delinquent/default financing occur, *musyarakah mutanaqisah* is better able to survive and control the situation. Under *bai' bithaman ajil*, on the other hand, the selling price stated in the contract restricts any restructuring or rescheduling of the financing facilities. It is not a good economic decision to draw up a new buy and sell contract, which is likely to incur further legal and administrative costs. (3) A contract for a property under construction needs a content that is not open to dispute, which can be provided under *musyarakah mutanaqisah*. When combined with *istisna'*, this type of contract clearly defines the responsibilities of the parties concerned. This is unlike *bai' bithaman ajil* which clearly involve the element of *gharar* when a property which is not yet exist is used as an underlying asset in the trading transaction. (4) *Musyarakah mutanaqisah* is an Islamic means of financing property, which has been accepted throughout the world. See, "Islamic Home Loans for Everyone", *The Star Online*, 12 June 2007.

<sup>51</sup> According to Mr K, Marketing Manager at one of the Islamic financial institutions in Malaysia (May, 2007), it is not yet available in Malaysia, although it is practised throughout the Arab world, particularly in the Gulf States. The reason appears to be that *musyarakah mutanaqisah* contract in Malaysia means joint venture financing between the bank and the corporate customer, and an individual cannot be a corporate customer. However, it is interesting to note that the Kuwait Finance House (one of three Middle East banks in Malaysia has recently offered *musyarakah mutanaqisah* for house financing to their retail customers in Malaysia. See, [www.kfh.com.my](http://www.kfh.com.my). See also, "Kuwait Finance House Introduces New Islamic Financing Product", *BERNAMA*, 8 May 2006.

discipline that the Islamic system has the potential of introducing in the financial system cannot, however, eliminate the need for regulation and supervision.”<sup>52</sup> Yet, they also point out: “Regulation should not, however, be so tight and comprehensive that it raises compliance costs unbearably and also strangles innovation and creativity.”<sup>53</sup> It is certainly true that since banks deal with deposits from the public, effective supervision and regulation are necessary to create public confidence and financial stability, and, moreover, to protect them from fraud and mismanagement. However, if the banks are to use their expertise most efficiently, then regulation should not be too stringent.

It has been stated in Chapter 3 that the financial system in Malaysia, which includes the Islamic financial institutions, is under the supervision of BNM as the central national bank. According to Satkunasingan and Shammugam, the Malaysian government implicitly and unilaterally guarantees all deposits in the banks in Malaysia. However, it gives no written guarantee to this effect.<sup>54</sup> Should a bank invest and lose depositors’ funds, consumers would be given to understand that the loss would not have to be borne by the bank alone and that the government would refund the depositors’ savings, even if only in part.<sup>55</sup>

The huge losses of BIMB have already been mentioned in section 5.2. Yet, since financial losses are related to supervision and regulation, this section investigates the case of BIMB in greater detail. In addition, the management of risk in both BIMB and BNM are briefly discussed to give an insight into their current practices.

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<sup>52</sup> M. Umer Chapra and Tariqullah Khan, *Regulation and Supervision of Islamic Banks* (Jeddah, Saudi Arabia: Islamic Research and Training Institute, Islamic Development Bank, 2000), p.17.

<sup>53</sup> Ibid.

<sup>54</sup> Satkunasingan and Shanmugan, op. cit., p.71.

<sup>55</sup> Ibid.

#### 5.4.1 BIMB: The Losses

Criticism of the losses incurred by BIMB has shown that managing risk is crucial from the point of view of not only the financial institutions but also that of the regulatory authorities and the government.

BIMB's losses have raised questions about Malaysia's banking system, for they followed the Asian financial crisis of 1997–1998, and also about political connections in the corporate and financial world. How strong and autonomous is the country's regulatory framework in scrutinizing questionable loans and decisions, especially in a free-rolling offshore financial centre such as Labuan?<sup>56</sup>

It has been mentioned in section 5.2 that most of the losses were attributed to Bank Islam Labuan Offshore Branch (BILOB).<sup>57</sup> BILOB is the conversion of Labuan Offshore Subsidiary (Bank Islam) [L] Ltd [BILL] on 10 December 2004. The loans were distributed in US dollars mainly overseas from 1998, the majority in 2002 and 2003.<sup>58</sup> BIMB's former Chief Executive Officer, Dato' Noorazman, said:

The Labuan outfit appeared to have operated without much oversight when it was subsidiary. It had a separate Board. And it had management sitting on the Board as well, which is not right. Loans were given out generously without sufficient understanding of the risks involved, including country and project risks.<sup>59</sup>

It is also stated in BIMB's *Annual Report* (2005) that the "conversion of BILL into an offshore branch of the Bank led to the adoption of stricter non-performing financing (NPF) regulations as a more stringent risk management framework, resulting in more prudent financial reporting of BILOB activities."<sup>60</sup> The closer super-

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<sup>56</sup> Netto, op. cit.

<sup>57</sup> Bank Islam (L) Ltd (BILL) began its operations in 1997.

<sup>58</sup> Netto, op. cit.

<sup>59</sup> Ibid.

<sup>60</sup> Bank Islam (M) Berhad, *Annual Report* (2005), op. cit., p.4.

vision and tighter accounting standards for non-performing financing (NPF) revealed that the losses were much larger than that which its Kuala Lumpur head office had expected.<sup>61</sup> During the financial crisis, BIMB could not transfer the non-performing financing to Danaharta, as did other conventional banks, because Danaharta could not remove the loans from BIMB's records owing to its inability to take Shari'a-compliant loans.<sup>62</sup>

#### **5.4.1.1 CRITICISM OF THE LOSSES**

This disturbing and shocking news was also discussed in Parliament.<sup>63</sup> During the debate on the Budget for 2006 on 26 October 2005, Lim Kit Siang from the Democratic Action Party or DAP (an Opposition party), asked the government to give details of the results of the investigation. He also called for a White Paper to be tabled with a report on action taken against those responsible.<sup>64</sup> Salahuddin Ayub, from the Parti Islam Se-Malaysia or PAS (also an Opposition party), urged the Prime Minister to intervene in the BIMB affair, adding that those who misappropriated funds from Bumiputra agencies for their personal gain were traitors.<sup>65</sup> Dato' Mohamed Aziz, from the Barisan Nasional Party or BN (ruling coalition), said that the reaction to the losses seemed to suggest that it was "a small matter" or "not really important".<sup>66</sup> He urged that "those responsible should be heavily punished."<sup>67</sup> When winding up the debate on the 2006 Budget, Datuk Tengku Putera Tengku Awang, the Deputy Finance Minister, promised that the government had no intention of disguis-

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<sup>61</sup> Netto, op. cit.

<sup>62</sup> "New Management Takes Big Hit to Move Ahead Afresh", *New Straits Times*, 27 October 2005 (cited 8 July 2007).

<sup>63</sup> "No Cover-up on Bank Islam Losses", *The Star*, 27 October 2005 (cited 29 October 2005).

<sup>64</sup> Ibid.

<sup>65</sup> Ibid.

<sup>66</sup> Ibid.

<sup>67</sup> Ibid.

ing BIMB's losses and if there had indeed been negligence by an individual, then that person would be punished.<sup>68</sup> Earlier, on 25 October 2005, the Second Finance Minister, Nor Mohamed Yakcop, had told Parliament that the losses were due not to a failure of Islamic banking principles but to the negligence of some officers and that action would be taken against those concerned in the case.<sup>69</sup> The Prime Minister, Datuk Seri Abdullah Badawi, said that BIMB must quickly identify and act against those officers responsible for the bad loans, for negligence and inefficiency were not an excuse.<sup>70</sup> He added:

This is very important because banks are involved in business activities using other people's money and any action on the part of officers that can result in losses must be viewed very seriously.<sup>71</sup> Otherwise, there will be this perception that we are not serious about punishing the guilty party. In time, this will erode their confidence in banks.<sup>72</sup>

The Prime Minister also said that the loss had, to a certain extent, damaged the image of the Bank, though its integrity remained intact.<sup>73</sup>

Despite the public criticism of the losses, it was reported that, according to banking analysts, Malaysia's Islamic banking industry was in a healthy state and would not be affected by BIMB's losses.<sup>74</sup> The analysts pointed out that BIMB's losses were mainly due to the new management's decision to tackle bad debt and that the Bank's performance was not a systemic problem that would jeopardise the whole

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<sup>68</sup> Ibid.

<sup>69</sup> "Pegawai Cuai Punca Bank Islam Rugi RM700 juta", *Utusan Malaysia*, 24 October 2005. Cited 26 October, 2005.

<sup>70</sup> "Hukum Pegawai Cuai Sebabkan Bank Islam Rugi RM700 juta", *Utusan Malaysia*, 27 October 2005. Cited 26 October, 2005.

<sup>71</sup> Ibid.

<sup>72</sup> Ibid.

<sup>73</sup> Ibid.

<sup>74</sup> "Islamic Banking Industry Healthy", *New Straits Times*, 8 October 2005. Cited 9 October, 2005.



establishment.<sup>75</sup> On the other hand, Edmund Terenze Gomez, a political economist at the University of Malaysia and temporarily attached to the United Nations Research Institute for Social Development in Geneva, felt that the Ministry of Finance, too, should share collective responsibility for the regulatory weaknesses that contributed to BIMB's dilemma.<sup>76</sup> He said:

The regulatory bodies can't be held solely responsible, given the questionable issue of their autonomy. The Executive has to be held accountable [as well], especially since the Ministry of Finance is led also by the Prime Minister.<sup>77</sup>

He added:

The problem, however, with institutions like BIMB, which is majority-owned by government agencies, is that the activities are monitored and regulated by bodies that have a say over managerial appointments and presumably, by extension, over decision-making by directors. The BIMB crisis suggests that we may have a problem of selective corporate governance, or worse, outside interference in the management of this bank. Given the extent of the power of the Executive over other arms of government, this would suggest that regulatory bodies may not have enough autonomy to act independently. This crisis suggests that since the government presently has ownership and control of a large number of publicly listed firms and banks, it should seriously review a number of issues including devolution of power to regulatory bodies and ensure that the directors of these quoted firms and banks have the capacity to act independently and transparently.<sup>78</sup>

According to Netto, the Bank's woes also put the Labuan Offshore Financial Services Authority (LOFSA)<sup>79</sup> uncomfortably under the spotlight. It was reported that the lack of autonomy from the Executive and the central bank was highlighted in an International Monetary Fund assessment report released in December 2004 – at about the same time that BIMB was coming under closer scrutiny. An IMF team conducted an offshore financial centre assessment to gauge the extent to which

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<sup>75</sup> Ibid.

<sup>76</sup> Netto, *op. cit.*

<sup>77</sup> Ibid.

<sup>78</sup> Ibid.

<sup>79</sup> Ibid. LOFSA, established in 1996, is a statutory body that reports to a Board (authority) and to the Finance Minister on the overall management and regulation of Labuan.

Labuan's regulatory and supervisory arrangements complied with internationally accepted standards and good practices. Some of the findings were as follows:

Autonomy of LOFSA within Malaysian government not fully transparent. Develop memoranda of understanding (MoUs) between LOFSA and the Finance Ministry and LOFSA and BNM (the central bank), spelling out Executive and operational arrangements.

All the essential elements for suitable framework for financial supervision with LOFSA staff well-trained and experienced and funding adequate. But it is noted that non-performing loans are relatively high in the banking sector and demand for credit has been soft.

Average profitability is low and a number of banks and insurance companies maintain only a token presence. Although supervision has been stepped up, LOFSA staff resources for the compliance function are currently insufficient to conduct effective on-and-off-site supervision across the whole offshore industry.

Corporate governance standards for offshore financial institutions are not well developed.

Crucially, the IMF team recommended that "loan classification and provisioning rules should be rigorous and the capital adequacy risk-weight rule should be revised to Basel standards."<sup>80</sup>

When the losses were blamed on the Labuan branch, BIMB had a reputation in the financial market for being the spoilt child of the Malaysian Ministry of Finance. The general perception of the Bank was that of a Muslim financial fraternity or government development institution, whereas, in reality, BIMB had a commercial banking licence.<sup>81</sup> Interviews held by Dato' Mohammad Yusuf Haji Nasir, former Chairman of BIMB, with Islamic bankers revealed that certain crucial matters had been overlooked by the management and regulatory authorities in BIMB.<sup>82</sup> This

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<sup>80</sup> Ibid., See also, <http://www.imf.org/external/pubs/ft/scr/2004/cr04391.pdf>

<sup>81</sup> "A Litany of Lost Opportunities", *Islamic Banker*, November/December 2005.

<sup>82</sup> The interviews had been conducted a year earlier, though this fact was revealed only after the news of the huge losses incurred by BIMB.

“seasoned Malaysian banking elder” had been brought in by BNM as Chairman in December 2000. Below are some of the important points made by the former Chairman:

I was surprised at what I found. The composition of the Board was not appropriate in the sense that there were no bankers or Board members who were familiar with banking. I am not criticising the past Chairman, because he was also put there by the authorities. He is not a banker.

I was surprised at the way things were done; the way the Board meetings were conducted. I knew I had a very tough task ahead. BIMB at that time was not run as a commercial bank. In the public perception, BIMB was just like Bank Industri or Bank Pembangunan – a government development bank. I told the senior management that this kind of perception must be erased from the minds of the general public because BIMB is a commercial bank with a commercial licence governed by the Islamic Banking Act (BAFIA).

The branches I saw were not what a branch of a bank ought to be. They were old and dilapidated. I was also informed that the non-performing financing (NPF) account was very bad. Nobody was looking at it at all. At my previous bank during the 1998 financial crisis when we had an NPF account of 40 percent, we immediately zeroed in on the NPF account; on the credit policy; and the staff itself. If the credit policy is not there, the NPF will just balloon. I mentioned this to the management of BIMB, but somehow the reception was not there. There was also no reporting to the Board what was happening.

BIMB was established in 1983. The first ten years – it was new and introducing a new system of banking. After 1993, the Bank should have been more transparent and commercial. It may be that the management themselves felt that they were tempered by the authorities. When I went in, I suggested that Bank Negara inspectors come in and audit BIMB like any other commercial bank, which they did. They uncovered a lot of things, which the management of the Bank were unaware were happening. The fact remains that the reporting by BIMB hitherto was so bad. The management of the Bank seemed lost.

The credit policy assessment and review were very weak. This is where the NPF account comes in. There was no one with the responsibility of looking after the account. You give out the loan and that’s it. Nobody followed through.

The staff in general at BIMB did not think businesslike or commercial. I told them that Islam is not like this. You have to be businesslike and commercially-minded. If the staffs make an error, you don’t reprimand them. This is not the Islamic way. You have to reprimand them. The bank had Board members who knew nothing about banking, let alone commercial banking. I was very worried that the policies of the Bank were coming from the Board and they were not really with [banking and commercial] substance.

Another thing which I insisted on was a strong Board, and for some members also to sit on the Boards of subsidiaries of the Group, such as the Venture Capital, *Ijara*, Asset Management and *Takaful* entities. Before I arrived, there

was very little participation of Board members in these subsidiaries. The management themselves were Board members of the subsidiaries, which I think is not the way forward. I want the Board members to oversee these subsidiaries, to help synergise their activities perhaps through co-branding. The branding of BIMB is good and we need to leverage this.<sup>83</sup>

#### **5.4.1.2 CURRENT FINANCIAL HIGHLIGHTS OF BIMB**

Finally, on 10 July 2006, the Parliamentary Secretary to the Finance Ministry, Datuk Hilmi Yahya, told Parliament that the losses incurred by BIMB had been due to weak credit management in its offshore operations in Labuan, not to any misappropriation.<sup>84</sup> He said that the losses were an isolated case and did not affect the Bank's domestic operations. Meanwhile, the Bank had taken steps to strengthen its corporate governance and risk and credit management framework in Labuan.<sup>85</sup> However, it seems that there was no further statement revealing the names of those who were responsible for the losses.<sup>86</sup>

For the financial year ended 30 June 2006, BIMB recorded a total net loss of RM1.29 billion, and as of that date, the Bank's total liabilities exceeded its total assets by RM277.8 million.<sup>87</sup> Despite the Bank's total income of RM960.6 million, the provision for non-performing financing (NPL) amounted to RM1.48 billion, resulting in a loss. The Managing Director of BIMB said that it should be profitable

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<sup>83</sup> Ibid.

<sup>84</sup> "Weak Credit Management Blamed for Bank Islam's Loss", *Bernama*, 10 July 2006.

<sup>85</sup> Ibid.

<sup>86</sup> Perhaps, with a view to maintaining the stability of the financial system, especially the Islamic financial system, the government is very careful to announce the outcomes. The importance of the Islamic banking system can be seen from the statement by Datuk Dr Gan Khuan Poh (Chairman of the Economic Society of Malaysia), who said in 2004 that there was an US\$200 billion (RM760 billion) cash investment fund in the market, "moving towards" the Islamic banking system after having been drawn from the banking system in the United States after 11 September 2001. He added that the Western countries such as Britain and Switzerland had realized this potential and begun to establish Islamic financial systems to grasp those opportunities. See, "Dana RM760b Berlegar Cari Peluang Pelaburan", *Utusan Malaysia*, 9 December 2004. Cited 10 December 2004.

<sup>87</sup> Bank Islam (M) Berhad, *Annual Report* (Kuala Lumpur: Bank Islam (M) Berhad, 2006), p.39.

in the current financial year ending 30 June 2007. It was making efforts to implement elements of a turnaround plan, such as human capital development.<sup>88</sup> So far, there has been no negative reaction to the newspaper report of this result on 27 October 2006, compared with the announcement in 2005, when the loss was even greater. Perhaps public confidence has been maintained, owing to the news that BIMB has received an injection of capital from the Dubai Investment Group and Lembaga Tabung Haji.

Despite the loss, the overall total deposits from customers increased from RM13.4 billion in 2005 to RM14.4 billion in 2006, as shown in Table 5.1.

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<sup>88</sup> BIMB received an injection of capital from the Dubai Investment Group (DIG) and Lembaga Tabung Haji, giving these investors a 40 per cent and 9 per cent stake respectively in the Bank. Group Managing Director of BIMB said: "Lembaga Tabung Haji is providing huge synergies in the domestic market, while Dubai Investment Group is providing a bridge to one of the fastest-growing economic regions in the world, both of which would boost BIMB's earnings recovery." See, [www.bankislam.com.my](http://www.bankislam.com.my), "BIMB Holdings Berhad Expects to Turn Around in the Current Financial Year and Bank Islam is Working on 'Total Solution' to Return to Profitability". (Cited 18 June 2006.)



**Table 5.1** Deposit Funds for Bank Islam (M) Berhad for financial years ended 30 June 2004, 2005 and 2006

<b>Fund</b>	<b>2004 RM'000</b>	<b>2005 RM'000</b>	<b>2006 RM'000</b>
<b>Non-Mudharabah Fund:</b>			
Demand deposits	2,686,075	2,954,160	3,650,270
Savings deposits	1,264,025	1,385,432	1,422,174
Negotiable Islamic Debt Certificates (NIDC)	328,026	747,951	2,480,933
Others	21,156	18,999	24,897
<b>Total</b>	<b>4,299,282</b>	<b>5,106,542</b>	<b>7,578,274</b>
<b>Mudharabah Fund:</b>			
Savings deposits	364,763	433,229	454,387
General investment deposits	2,903,708	3,110,483	2,417,239
Special investment deposits	3,692,048	4,823,817	3,927,516
Others	9,100	9,100	9,100
<b>Total</b>	<b>6,969,619</b>	<b>8,376,629</b>	<b>6,808,242</b>
<b>Total deposits from customers</b>	<b>11,268,901</b>	<b>13,483,171</b>	<b>14,386,516</b>

Nevertheless, Table 5.1 also shows a reduction in deposits from customers from the *mudharabah* fund. Despite the increase in the non-*mudharabah* fund, there was a fall in the *mudharabah* fund from RM8.4 billion in 2005 to RM6.8 billion in 2006. The *mudharabah* fund in 2006 is also lower compared with that of 2004 (RM6.9 billion). This is a large amount and it could be said that customers were taking precautions by carefully selecting the products and services that they considered high risk, since BIMB declared the loss in that financial year.<sup>89</sup> Empirical

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<sup>89</sup> Mr Ahmad Mudahir Omar, Assistant General Manager, Strategic Risk Control and Compliance, Risk Management Division of BIMB, said: "Reduction in *mudharabah* deposits

research could be conducted to highlight the factors contributing to the decline. The case of BIMB shows that the competence and efficiency of the staff are crucial, bearing in mind that the Bank's reputation is at stake, for it carries the name of Islam.

#### **5.4.2 BNM: Management of Risk**

In April 2004, the BNM announced the timetable of a two-phase implementation of the New Basel Capital Accord (Basel 2) for conventional banking.<sup>90</sup> BNM then issued a similar schedule for the Islamic banks in September 2004. However, as stated by David Vicary, the operation of Islamic financial institutions must comply with both international best practice (standards and guidelines) and the Shari'a.<sup>91</sup> Although Basel 2 is sufficiently flexible to accommodate institutions offering Islamic financial services, nevertheless, it does not cover (1) compliance with the Shari'a; and (2) risks arising from the unique features of the Islamic financial system such as the profit/loss-sharing principles. He adds that the design of the Basel 2 mechanism is such that it could penalize Islamic banks as a result of the unique structures of Islamic banking products and services. Since there are no international standards and

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is not due to the loss. The main reason is the strategy to reduce what is payable, because the loan and deposits ratio has always been low, yet capital is limited."

<sup>90</sup> Basel 2 (also called the New Accord – International Convergence of Capital Measurement and Capital Standard: A Revised Framework) is the second Basel Accord. It defines capital and sets minimum capital requirements for internationally active banks in the G10 countries. Banking supervisors are the guardians of these standards and are expected to enforce them in their respective jurisdictions. See, Chapra and Khan, op. cit., p.34. Basel 2 uses the concept of three pillars – (1) minimum capital requirements; (2) supervisory review; and (3) market discipline – to promote greater stability in the financial system. The earlier Accord, Basel 1, was adopted in 1988. Previously, there were no standard definitions of bank capital and minimum capital requirements. By 1998, almost all countries had officially changed their capital requirements to conform to the Basel Accord (see Joel Bessis, *Risk Management in Banking*, 2nd edn (Chichester, UK : John Wiley, 2002), p.189. It has also been implemented in many IDB member countries in addition to the G10 (Chapra and Khan, op. cit., p.34). Therefore, although initially designed for the industrialized world, international operations soon ensured a universal standard (Bessis, op. cit., p.189).

<sup>91</sup> David Vicary, "Risk, Risk-Taking and Risk Management Process in Islamic Financial Services". Paper presented at the seminar on Risk Management in Islamic Financial Services, Kuala Lumpur, 26–27 April 2005.

guidelines for Islamic financial institutions to follow, it seems that Bank Negara Malaysia has to use Basel 2 as the international best practice.

In February 2006, the Islamic Financial Services Board (IFSB)<sup>92</sup> issued two standards – the Capital Adequacy Standard (CAS)<sup>93</sup> and the Guiding Principles of Risk Management (Guiding Principles)<sup>94</sup> – for institutions offering Islamic financial services. The CAS and the Guiding Principles are the first two international standards governing the prudential regulatory and supervisory framework of Islamic banking institutions. According to its *Annual Report* of 2005, BNM will collaborate with the Islamic banking institutions to ensure a smooth and successful implementation of both standards.<sup>95</sup> It is hoped that these two standards and guidelines will be adopted by all the Islamic financial institutions both in Malaysia and throughout the world.

In addition, BNM introduced the Bank Negara Malaysia *Sukuk Ijarah*, a new Islamic monetary instrument for liquidity management, thus increasing its range of instruments for managing liquidity in the Islamic money market.<sup>96</sup> BNM also issued

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<sup>92</sup> The IFSB was officially established in 2002 and went into operation on 10 March 2003. Malaysia, as the host country, passed the Islamic Financial Services Board Act 2002, which gives the IFSB the immunity and privileges usually granted to international organizations and diplomatic missions. The IFSB serves as a body setting international standards for regulatory and supervisory agencies. Its 94 members include 22 regulatory and supervisory authorities as well as the International Monetary Fund, the World Bank, the Bank for International Settlements, the Islamic Development Bank, the Asian Development Bank, and 67 financial institutions from 17 countries. Cited 22 November 2006 from [www.ifsb.org](http://www.ifsb.org).

<sup>93</sup> Bank Negara Malaysia, *Annual Report* (Kuala Lumpur: Bank Negara Malaysia, 2005), p.157. The CAS provides guidance to Islamic banking institutions on requirements for minimum capital adequacy to cover credit, market and operational risk. This is equivalent to the Basel 2 Capital Framework.

<sup>94</sup> Ibid. The Guiding Principles provide specific guidelines for establishing and implementing effective practices in risk management. Fifteen principles are applied in managing six categories of risk arising from Islamic contracts: credit, equity investment, market, liquidity, rate of return and operational risk.

<sup>95</sup> Ibid.

<sup>96</sup> Ibid., p.159.

the Guidelines for the Governance of the Shari'a Committees for Islamic Financial Institutions, which came into effect on 1 April 2005.<sup>97</sup> The BNM also evaluates the effectiveness of the Shari'a committees in providing correct advice and validating the compatibility of the Shari'a in the banks' daily operations, such as observing the adequacy of firewalls to ensure no mixing of Islamic and conventional funds in the Islamic window operations. Furthermore, the internal auditors of Islamic financial institutions are also required to ensure that these institutions comply with the Shari'a principles by formulating an appropriate and comprehensive audit programme and undergoing the necessary training to implement it.

On realizing that the human factor is the crucial element in Islamic banking, BNM took the initiative to establish a fund of RM200 million for Shari'a scholars of Islamic finance. This fund will finance Shari'a research activities, scholarships for Shari'a studies and the organization of the annual international Shari'a scholars' forum. Meanwhile, the International Centre for Education in Islamic Finance (INCEIF) was launched in March 2006, its operations to be supported by an endowment fund of RM500 million allocated by BNM. The objective of the INCEIF is to produce high-calibre practitioners and professionals in Islamic finance as well as specialists and researchers in the disciplines of Islamic finance. At the Governor's Luncheon Address, Dato' Sri Zeti Akhtar Aziz, Governor of BNM, said that the establishment of the INCEIF represented an investment in human capital to support the global development of the Islamic financial services industry. Sustaining and

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<sup>97</sup> Ibid., p.161. The number of Shari'a advisers on the Shari'a Committee for Islamic banking institutions and *takaful* companies has increased markedly following publication of the Guidelines, and this would be a means of enlarging the number of Shari'a experts in the country. Also included on the Committee are former judges, legal practitioners, economists, and academics in the field of *fiqh al-mu'amalat*. It is hoped that this combination of background knowledge and expertise will greatly enhance national development.

supporting the growth of the industry required talent and expertise to promote innovation and improve performance.<sup>98</sup> In addition, initiatives were taken to create consumer education and awareness. Several road shows were organized by the Association of Islamic Banking Institutions Malaysia (AIBIM) to state capitals around Malaysia, in some of which BNM itself took part.<sup>99</sup>

To enhance corporate governance in Islamic banks, the Guidelines on Directorship of Islamic Banks were issued in March 2004. Their purpose is to strengthen the effectiveness of the board of directors, which would assume full responsibility for the overall management of an Islamic bank.<sup>100</sup> To strengthen the legal framework, the Hire Purchase Act 1967 is being reviewed to cover Islamic purchase contracts, while other relevant legislation, including the National Land Code, the Companies Act 1965, the Civil Law Act 1956 and the Contract Act 1950, is being studied.<sup>101</sup> This is part of the action taken by the Malaysian government to make legislation consistent with the Shari'a, to remove obstacles to compliance with the Shari'a in product development and innovation and also to encourage participation in Shari'a instruments.<sup>102</sup> In 2001, it was stated in the Financial Sector Master Plan that to expand the Islamic financial market, one of the actions to be taken would be to encourage *mudharabah* and *musyarakah* financing by establishing a special fund or subsidiary for that purpose. Islamic banks would need to conduct studies to identify potential

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<sup>98</sup> Zeti Akhtar Aziz, "Governor's Luncheon Address: Launching of INCEIF", *Bulletin INCEIF* (July 2006), pp.1–3.

<sup>99</sup> Bank Negara Malaysia (2005), op. cit., p.165.

<sup>100</sup> Bank Negara Malaysia, *Annual Report* (Kuala Lumpur: Bank Negara Malaysia, 2004), p.161.

<sup>101</sup> Bank Negara Malaysia (2005), op. cit., p.162.

<sup>102</sup> Ibid.



areas where these modes of financing would be most feasible.<sup>103</sup> However, to date, there has been no further development in this aspect of Islamic finance.

The action described above is part of what has been done so far to improve the system for Islamic banks to operate with BNM as the central bank.<sup>104</sup> It shows that BNM and the Malaysian government have the serious intention of further developing and exploiting the Islamic banking system. Nevertheless, it can be achieved only with the close supervision of the participants and the firm enforcement of the rules. Otherwise, the guidelines will be useless and could be described as “in the book guidelines only”.

#### **5.4.3 BIMB: Management of Risk**

Further analysis of BIMB’s annual report has found that only in the year ended 2004 was there a clear statement indicating the responsibilities of the Board of Directors in creating and implementing policies for the management of risk. This was in line with the instructions from BNM to adopt Basel 2 in September 2004. The Board of Directors is also responsible for ensuring the effective management of the internal

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<sup>103</sup> Bank Negara Malaysia, *Financial Sector Master Plan* (Kuala Lumpur: Bank Negara Malaysia, 2001), p.158.

<sup>104</sup> There have been further developments in the Islamic financial system in Malaysia. Prime Minister Datuk Seri Abdullah Ahmad Badawi has announced six major measures to help the sector become a leading international centre of Islamic financial services: (1) exemption from income tax for 10 years is to be granted to all Islamic banks and *takaful* companies that conduct their business in foreign currencies; (2) an additional exemption from 20 per cent stamp duty for 3 years is to be granted on instruments related to Islamic financing; (3) exemption from income tax for 10 years is to be granted to managers of local and foreign funds who manage Islamic funds for foreign investors; (4) personal tax relief on study fees, up to a maximum of RM5,000 per year, will be extended to Islamic studies conducted in institutions of higher learning, including the International Centre for Education in Islamic Finance; (5) tax deductions are to be given on expenses incurred in establishing an Islamic stock broking firm; (6) tax deductions on expenses incurred in the issuance of Islamic products are to be extended from the year of assessment 2008 to 2010. See, “Six Measures to Boost Islamic Finance”, *The Star Online*, 2 September 2006, [www.thestar.com.my](http://www.thestar.com.my). Cited 20 December 2006.

control mechanism.<sup>105</sup> It is assisted by the Risk Management Committee and the Audit and Examination Committee in discharging these roles. The Risk Management Committee is expected to formulate policies as well as identify, measure, manage, control and monitor the credit, market, liquidity, and operational risks.<sup>106</sup> The Committee consists wholly of non-executive directors and is chaired by an independent non-executive director. In the Bank's *Annual Report* for the financial year 2005, it is stated:

The Committee constantly reviews risk issues to ensure effective management of risk tolerance at the Bank. In addition, the Committee is entrusted to review and assess the adequacy of the existing risk management framework in addressing the various risk factors faced by the Bank.<sup>107</sup>

Meanwhile, the Audit and Examination Committee is responsible for ensuring a good internal control framework and compliance. It comprises four non-executive directors, of whom three, including the Chairman, are independent non-executive directors.<sup>108</sup> In addition, the Internal Audit Department is required to conduct a risk management audit. The audit plan includes reviews of the adequacy of risk management, operational controls, compliance with laws and regulations, and quality asset management efficiency. Parallel with BNM, BIMB will improve its risk-based audit techniques and staff competence. At the same time, it is the duty of the Shari'a Supervisory Council (SSC) to review and appraise the operations of the Bank's business and advise the directors to ensure that they do not include any elements not approved by Islam. The Bank is also required to establish a Management Risk Control Committee (MRCC), whose main responsibilities are to ensure the correct

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<sup>105</sup> Bank Negara Malaysia (2004), op. cit., p.10.

<sup>106</sup> Ibid.

<sup>107</sup> Bank Islam (M) Berhad (2005), op. cit., p.9.

<sup>108</sup> Ibid.

implementation of policies approved by the Risk Management Committee/Board of Directors and the effective management of operational issues.

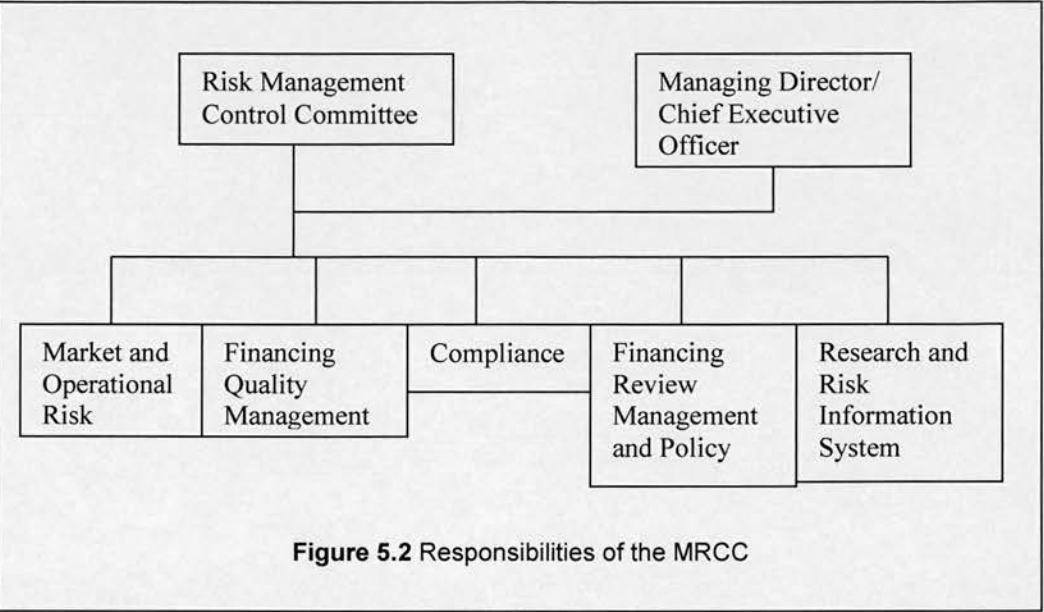


Figure 5.2 was compiled during fieldwork in April 2005. At that time, the Risk Management Control Committee (MRCC) was not fully established and there were still vacancies to be filled. The Committee comprises five divisions: market and operational risk, financing quality management, compliance, financing review management and policy, and research and risk information system, each division with its own responsibilities. From Figure 5.2, it appears that BIMB is concentrating on market risk, operational risk and credit risk, following the instructions by BNM to adopt the Basel 2 Accord.<sup>109</sup> Briefly, the Compliance Division deals with compliance with laws and regulations, while the Research and Risk Information System concentrates on systematic risk and risk related to the information system.

<sup>109</sup> Under the two-phase implementation, Islamic banks are given the option either to comply with the standardized approach for credit risk in 2008 or to move directly to the internal ratings-based approach in 2010. See, Bank Negara Malaysia (2004), op. cit., p.162.

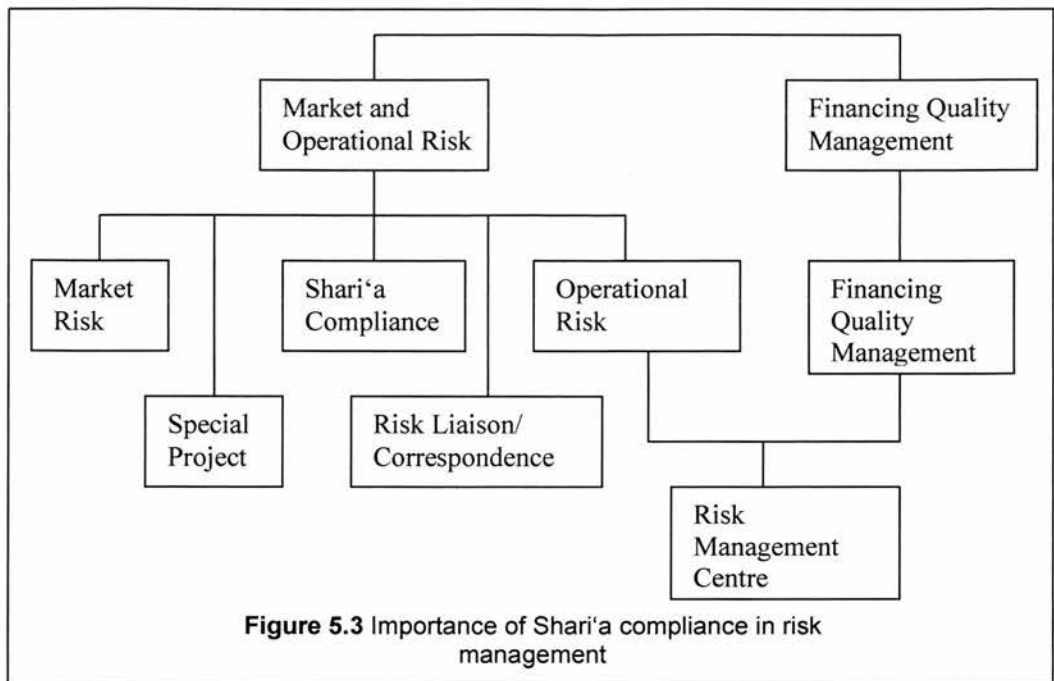


Figure 5.3, also compiled during fieldwork, shows that the Bank had realized the importance of including Shari'a compliance under market and operational risk. In an interview, Mr Nazri Chik, Assistant Manager of the Shari'a Compliance Division, said that the skills required for Islamic finance were unique, with priority given to an understanding of the Shari'a plus the knowledge of finance. He added that the Shari'a principles must be well established in every aspect of banking operations, including the design of products, contracts and their fulfilment, as well as asset and wealth management. The Bank believed that the Shari'a principles must be maintained by all levels of staff from the highest to the lowest, that is, from senior management to the clerical staff, since adherence to the Shari'a reflected the integrity of the institution. Therefore, to meet those objectives, Mr Nazri Chik and his division had taken on the responsibility of arranging training and a series of talks on the Shari'a for members of staff. He affirmed that much of the staff-training programme

would be handled by his division in collaboration with the Department of Human Resources.

It is also stated in BIMB's annual reports of 2004 and 2005 that one of the roles of the Shari'a Supervisory Council (SSC) is to provide education and training on *mu'amalat* or transactions based on Shari'a principles. It is also hoped that BIMB will fully implement these standards and recommendations for managing risk in its financial operations, especially to regain public confidence.

## **5.5 Remarks**

From the discussion in Chapter 4, it is clear that managing risk is important in every aspect of life. It is particularly true of banking, for the primary function of a financial intermediary is the mobilization of savings from the savers of funds to the users of funds. Therefore, as financial intermediaries, the financial institutions also act as risk-takers between these two parties. The aim of the financial intermediaries is to facilitate the procedures of placing savings or investments, as well as borrowing and lending. However, in performing their function of intermediation, banks face risks that affect their ability to compete and to meet the interests of their stakeholders, namely, their depositors, shareholders and regulators. All financial systems are vulnerable to fluctuations in interest rates and exchange rates, loan default, operational failures, natural disasters and a range of other human, managerial and environmental weaknesses. Therefore, financial institutions need to develop a robust system to tackle and manage risk and thereby protect their stakeholders.

In theory, the Islamic banks appear to be less vulnerable to volatility than their conventional counterparts, owing to the comparative advantage embedded in the principle of risk sharing. According to this model, any negative shock to the asset



returns of an Islamic bank is absorbed by both shareholders and investment depositors.<sup>110</sup> The holders of profit-sharing investment accounts in an Islamic system share in the bank's profit and losses alongside the shareholders, and hence are exposed to the risk of losing all or part of their initial investment. On the other hand, depositors in the conventional system have a fixed claim on the returns to the bank's assets, for they are paid a predetermined interest rate in addition to the guaranteed return of the principal regardless of the bank's profitability. In practice, however, the risk-sharing advantage is "neutralized" when Islamic banks, operating in mixed systems, pay their investment account holders a competitive "market" return, regardless of their performance and profitability.<sup>111</sup> As a result, equity holders' returns are displaced, creating for them a commercial risk.<sup>112</sup>

In Malaysia, the Islamic banks' deviation from the theoretical model has been the subject of debate. This practice is particularly noticeable in the Islamic banks' assets, for there has been a shift from profit/loss-sharing modes of financing activities such as *mudharabah* and *musyarakah* to other modes of financing such as *al- bai' bithaman ajil*, *ijarah* and *murabahah*. BIMB's over-reliance on the non-PLS modes of financing had a marked impact during financial crisis in 1997. BIMB saw its profit margins reduced during the period of rising interest rates in 1997.<sup>113</sup> Since BIMB was unable to increase profit rates on the fixed rate *al- bai' bithaman ajil* financing, the result was lower profit margins as rising interest rates drove up the

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<sup>110</sup> Discussion in section 4.5.3.

<sup>111</sup> Dahlia A. El-Hawary, Wafik Grais and Zamir Iqbal, "Regulating Islamic Financial Institutions: The Nature of the Regulated". Paper presented at the International Conference on Islamic Banking: Risk Management, Regulation and Supervision, held in Jakarta, 30 September – 2 October 2003), p.17.

<sup>112</sup> Ibid.

<sup>113</sup> Rosly, op. cit., p.477.

cost of its funds.<sup>114</sup> However, conventional banking showed a creditable performance, for floating rate loans were automatically adjusted upwards with the rise in interest rates.<sup>115</sup> In addition, BNM admitted in its *Annual Report* of 1997 that the economic turmoil had revealed structural weaknesses in Islamic banking.

It can be said that Islamic banks in Malaysia face serious challenges when operating under a dual system in comparison with those operating under a single Islamic system. Owing to their structure and the intermediation model that Islamic banks in Malaysia follow to compete with the conventional banks, innovation and product development are particularly important. Nevertheless, in this chapter, it has been found that structural issues such as existing bank regulations, the tax system and other regulatory factors have restricted the ability of the Islamic financial institutions to launch innovative products. This situation is of concern to the Islamic banks not only in product innovation and development. It has been stated by Chapra and Ahmed that the most important stakeholder is Islam itself.<sup>116</sup> If the Islamic banks do not perform well, those who declare the Islamic system to be out of step with the modern world might try to put the blame on Islam, even though Islam itself might have nothing to do with it.<sup>117</sup> The losses of BIMB show that an insufficient understanding of the risks can put a bank in a very vulnerable position. In the case of BIMB, it also highlights the urgent need for the closer supervision and regulation of banks because they are using other people's money. Development should not be promoted without also ensuring a safe banking system in which the payment

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<sup>114</sup> Ibid.

<sup>115</sup> Ibid.

<sup>116</sup> M. Umer Chapra and Habib Ahmed, *Corporate Governance in Islamic Financial Institutions* (Jeddah, Saudi Arabia: Islamic Research and Training Institute, Islamic Development Bank, 2002), p.14.

<sup>117</sup> Ibid.

structure is protected from instability. The analysis in this chapter has shown that the weaknesses in the management of the Bank itself as well as the lack of close monitoring by the supervisory authorities (BNM) contributed to the losses. The role that the supervisory authorities are expected to play is to ensure fair and honest dealing with all the stakeholders by proper regulation and supervision. It is also worth noting that customers placing deposits in Islamic banks have to bear only the risks normally attached to these accounts, for they are not affected by other factors such as political interference.<sup>118</sup> Thus, effective corporate governance<sup>119</sup> is needed. As Chapra and Ahmed point out:

Effective corporate governance in banks as well as the firms that use bank funds is one of the most important pillars of the new environment that needs to be created to replace the old-socio-economic environment that no longer exists. Unfortunately, however, corporate governance is considered to be generally weak in the corporations of the most developing countries. This is because all the institutions that play a crucial role in disciplining markets and ensuring efficiency and integrity are not well developed in these countries. Information asymmetries are more severe, market participants less experienced, and regulations, even if they exist, do not get enforced effectively and impartially because of political corruption and the general weakness of judicial systems. Disclosures are also not adequate and accounting practices are not well developed. Consequently, these corporations suffer from inefficiencies and equities that adversely affect all stakeholders. The adverse effects of effective corporate governance can be more serious in the case of financial institutions because the number of their stakeholders is much larger and the systemic risks are much greater.”<sup>120</sup>

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<sup>118</sup> This chapter has shown that it is believed that the banking sector in Malaysia has “not [been] independent of politicians who interfered with the central banks”. See, Satkunasingam and Shanmugam, *op.cit.*, p.77. The IMF report also revealed that the “autonomy of LOFSA within the Malaysian government is not fully transparent” and “corporate governance standards for offshore financial institutions are not well developed.” See, Netto, *op. cit.*

<sup>119</sup> Satkunasingam and Shanmugam, *op.cit.*, p.77, state that Malaysian Code on Corporate Governance 2000 has not addressed how to protect the independence of the management board of the companies from political influences. They also raised up the question whether Malaysian Code of Corporate Governance can be fully implemented, for it is currently seen as an example of “law in books” rather than “law in action”

<sup>120</sup> See, Chapra and Ahmed, *op.cit.*, p.8.

He adds:

Without effective corporate governance, it may not possible to strengthen Islamic banks and to enable them to expand rapidly and perform their role efficiently. This need will become more and more complex – problems which erode their ability in the long run to meet successfully the challenges that they face”.<sup>121</sup>

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<sup>121</sup> Ibid., p.10.

## Conclusion

This study has explored the salient features of the Islamic banking system with the focus on risk and its management. Since a bank's prospects depend largely on its ability to manage risk, this is a vital element of banking operations, particularly in the Islamic banking system, whose unique features make it more vulnerable to risk. The discussion below draws the conclusions from the findings throughout the thesis.

The prohibition of *riba* is indisputable according to the Qur'an and Sunna and this is accepted by the four schools of legal thought in the Shari'a. Nevertheless, each of these schools takes a different view of *riba*, which makes it one of the most debated topics among the *fuqaha* and Islamic scholars. Despite the issuing of several fatwas by certain scholars permitting interest in the banking system, most still believe that if a bank is to conform to the Shari'a, then it is essential that *riba* be eliminated from its operations.

An analysis of Islamic economics has found that it has been designed to cater for the welfare of God's creation by the establishment of harmony between the moral and material needs of human beings and the realization of socio-economic justice and brother/sisterhood in human society. Historical evidence shows that financial activities have existed since the early stages of human civilization, so clearly, this has always been an important aspect of human life. Until the Middle Ages, partnership (*mudaraba*) was the main feature of business. However, as business expanded, there was an urgent necessity (*darura*) for financial intermediaries so that the community could maintain its economic strength. Critics question certain areas of Islamic economics and highlight loopholes that should be examined and closed. Since there



has never been a blueprint of Islamic economics, Muslim intellectuals and economists face the challenge of constructing a system suitable for modern times. This will require careful thought. Scholars such as Syed Haider Naqvi and Zia ul-Haque point out that although *mudaraba* is lawful according to the Shari'a, there is nothing sacred about it. They also ask whether it is the best principle on which an Islamic economy should be based as visualized by scholars of Islamic economics, bearing in mind that some of its theory does not resemble the real world of today. Islamic scholars refer to their economic theory, whose standpoint is how individuals, groups or governments should perform in a perfect Islamic community. However, in reality, some Muslims do not behave in the manner expected of them by the Qur'an. As pointed out by Dar and Presley, although the theoretical treatment of Islamic finance offers much more support for its introduction, however, it has proved extremely difficult to implement in practice.<sup>1</sup> They also suggest that much could be learnt from the Western approach, which "values empirical investigation as a means to testing the 'realisability' of economic theory", for there has been reluctance among Islamic scholars to undertake empirical testing.<sup>2</sup>

The first Islamic bank, Mit Ghamr Local Savings Bank, was initially adapted from the concept of the German savings bank. However, its founder never made any reference to Islam in the early stages of its operation, lest the project be rejected, which indicates the over-riding influence of Western financial systems. However, the

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<sup>1</sup> Humayon A. Dar & John R. Presley, "Islamic Finance: A Western Perspective", *International Journal of Islamic Financial Services*, vol.1, no.1 (April-June, 1999), pp.3-12. The authors briefly discuss modern Western economic thought and agree with its underlying basis that "in reality, Man is selfish, groups act in self-interest, indeed, individual governments act in self-interest, and even groups of countries (like the European Union) in the main act in their own interests – occasionally to the detriment of other countries."

<sup>2</sup> Ibid.

impressive expansion of Islamic banking during the last twenty years of the twentieth century is evidence of the increasing desire of Muslims to conduct their financial activities according to Islamic teachings. Since the global Muslim population is large and continuing to increase, there is still a sizeable market to be tapped.

Malaysia is leading the Islamic banking industry with a well-established system. Malaysia being a multi-racial and multi-cultural country with a particular historical background, its government opted for a “dual banking” system to avoid offending certain groups of its citizens. The gradual approach to Islamization is preferred to prevent sudden changes that could result in serious economic and social upheaval. However, the implementation of profit/loss-sharing modes of financing has made very little progress, not only in Malaysia but also globally, which shows the reluctance of Islamic financial institutions to accept the very high risk associated with this type of investment. Clearly, very careful risk management is essential if an Islamic banking system is to succeed. More innovation is needed, in particular, the creation of new tools to assess risk more accurately, such as in the area of derivatives. However, innovation is also limited by the lack of expertise in the industry as well as the differences in the opinions of the schools of legal thought, as manifested by their scholars.

In addition, to protect the interests of the stakeholders of Islamic banks, the structure of the existing bank regulations, the tax system and other regulatory issues need special attention by the government. It is fair to point out that the conventional banking system in Malaysia has developed from a basis of research and experience over a much longer period and has an institutionalized and sophisticated infrastructure regulated by sound legislation. The Islamic banking system needs the

type of support similar to that given to the conventional banking system, such as an effective legal framework. If the necessary support is not provided, then the Islamic banks will not be able to compete with the conventional banks, especially under the dual banking system that is operated in Malaysia.

Following the huge losses in 2005 and 2006 as a result of poor risk management in BIMB, critics have also raised the question of dereliction of duty on the part of the management, the regulator and the government. One lesson in particular to be learned is that sound regulation and supervision are essential to support the system. If not, the Islamic financial system in Malaysia will be regarded as an institution established to promote political interests or agenda to attract international funds by using the name of religion, that is, Islam. As a result of its losses, BIMB has realized the importance of human capital and has developed an innovative risk management framework. For their part, BNM and the Malaysian government have given serious attention to the further development and exploitation of the Islamic banking system. In Malaysia, risk management in the Islamic banking system has reached a level to enable it to compete fully with its conventional counterpart. Although the system is not yet perfect, the initiative shows the serious intention of the government to develop it in parallel with the conventional system. Nevertheless, again, it can be achieved only with the close supervision of the participants and the firm enforcement of the rules. If not, the guidelines could be described as “theoretical” guidelines only.

Finally, although the growth of Islamic banking is encouraging, however, owing to the different schools of legal thought, there does not appear to be a single definition of an Islamic banking product, or even of Islamic banking itself. There is clearly a lack of standardization in the system. Uncertainty about what is and is not

permissible has so far prevented standardization, which could complicate risk assessment for both the banks and their customers. For example, banking products considered Shari'a compliant in Malaysia are unacceptable in Saudi Arabia. In the interests of the general public, differences of opinion from different schools of thought should be put aside to bring about unity and progress.<sup>3</sup>

Another factor to be addressed is the lack of human capital, namely, the insufficient standard of competence and efficiency in the Islamic banking industry, not only among bank staff but also on the Shari'a Supervisory Boards (SSBs). Since the SSBs are responsible for scrutinizing the operations of Islamic banks, they must have a good knowledge of banking as well as the Shari'a. However, the SSBs appear to be dilatory in issuing fatwas concerning certain questions, for instance, whether it is wrong for Islamic banks to use the interest rates as a benchmark for setting their mark-up percentage.<sup>4</sup> Although this appears to be a simple question, yet it requires serious discussion by the SSBs, which should give a constructive answer and issue a definitive fatwa applicable to not only Malaysia but also the whole world. A point of concern here is whether the members of the SSBs have a sufficient knowledge of modern financial instruments as well as the Shari'a.

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<sup>3</sup> In his speech at the Second World Islamic Economic Forum in Islamabad, Abdullah Badawi, the Prime Minister of Malaysia, raised the question of the differences among the *madhahib*. He stated that these must be resolved first, for they prevented Islamic unity. See, Kadir Dikoh, "Barat Ambil Kesempatan Perbalahan Antara Mazhab", *Berita Harian*, 9 November 2006.

<sup>4</sup> Sudin Haron, "Profit Sharing: Questions that Need to be Revisited", *Bulletin INCEIF* (2006), p.6. Haron states that there are suggestions that the calculation of ratio and percentages in Islamic banks should be based on the market rate of interest. However according to Haron this idea has been rejected by eminent scholars of Islamic banking, such as M.N. Siddiqui, Ziauddin Ahmad and M. Fahim Khan.

However, financial liberalization enabled three Islamic banks from the Middle East, namely, the Kuwait Finance House, al-Rajhi Banking and Investment Corporation, and a consortium of Islamic financial institutions represented by the Qatar Islamic Bank, RUSD Investment Bank Inc. and Global Investment House, to operate in Malaysia from 2004. It is interesting to remember as noted above in chapter 5 that the Kuwait Finance House, instead of offering *al-bai' bithaman ajil* for house financing, has recently offered *musyarakah mutanaqisah* to their retail customers. Over the coming years, it will be interesting to see how the entry of international players will enable their distinctive capabilities and strengths to be incorporated into the Malaysian Islamic banking system as well as foster greater harmonization in the interpretation and understanding of the Shari'a.



## Glossary

***Akhlaq***

Ethics and morality.

***Amana***

Trust.

***'Aqida***

Theological creed.

***Baraka***

A blessing, any benefit bestowed by God, especially one that increases.

***Daman***

Guarantee.

***Darura***

Necessity.

***Faqih***

(plural – *fuqaha*): A man learned in the knowledge of *fiqh*, who, by virtue of his knowledge, can give a legal judgment.

***Fiqh***

The science of applying the **Shari'a**.

***Fiqh al-mu 'amalat***

Islamic law of transaction.

***Ghabn***

Fraud, cheating, swindle. It can also mean "loss" when *ghabn* enters a contract without either party being aware of it.

***Gharar***

Literally, deception, danger, risk and uncertainty. Technically, exposing oneself to excessive risk and danger in a business transaction as a result of uncertainty about the price, quality and quantity of the goods or services, the date of delivery, the ability of either the buyer or the seller to fulfil his/her commitment, or ambiguity in the terms of the deal.

***Gharar fahish***

Excessive *gharar*, sufficient to invalidate the contract.

***al-Gharar al-mutawassit***

Average *gharar*.

***Gharar yasir***

Moderate *gharar*, a low level of *gharar* that is tolerable because it may be unavoidable.

***al-Ghurum bi al-ghunm***

(entitlement to a return, resulting from the liability of risk).

***Ghurur***

Arrogance, self-delusion, beguilement.

***Haja***

General need.

***Hajjat al-nas***

Public need.

***Halal***

Permissible in the **Shari'a**.

***Haram***

Unlawful according to the **Shari'a** and therefore punishable by God.

***Hasa***

A type of sale whose outcome is determined by the throwing of a stone. (Since it entails *gharar*, it is forbidden.)

***Hiba***

A gift.

***'Ibada***

Act of worship.

***Ihtikar***

Hoarding, monopoly.

***Ijab wa qabul***

Offer and acceptance.

***Ijma'***

Consensus, particularly that of the people of knowledge among the Muslims on matters of *fiqh*.

***Ijtihad***

Technically, a jurist's efforts to deduce a rule or reach a judgement according to evidence from the Islamic sources of law, mainly the Qur'an and the Sunna.

***'Illa***

Underlying reason, ground.

***Istisna'***

Contract of manufacture.

***Jahala***

Ignorance.

***al-Kharaj bi al-daman***

The right to the yield from an asset by the one who is liable for that asset.

***al-Khida***

Fraud.

***Madhhab***

(plural – *madhahib*): A school of Islamic law. The four main schools are the Hanafi, Maliki, Shafi'i and Hanbali.

***Makruh***

Reprehensible, though not unlawful in the **Shari'a**.

***Mandub***

Recommended – its performance is not compulsory and it promises rewards, while its omission is not punished.

***Maslaha mursala***

Unrestricted public interest.

***Mata' al-ghurur***

Objects of *ghurur*.

***Mubah***

Permissible in the **Shari'a**.

***Mujtahid***

A person qualified to perform *ijtihad*.

***Qiyas***

Logical deduction by analogy. **Qiyas** is the fourth source of the **Shari'a**. It is the legal method used for extending the law beyond what is stated in the authoritative legal sources or it is an extension of a precedent. It is not the establishment of a fresh ruling.

***Raf' al-haraj***

Removal of hardship.

***Ra'y***

Opinion, personal discretion – a legal decision based on the use of commonsense and personal opinion in cases where there is no explicit guidance in the **Qur'an** and **Sunna** and where it is not possible to use analogy.

***Salam***

Advance purchase.

***Shahada***

Legal testimony in a court of law.

***Shari'a***

Literally, a way. Technically, the way of God as shown by Islamic Law based on the **Qur'an** and the **Sunnah** of the Prophet.

***Sunna***

The customary practice of a person or group of people. **Sunna** refers to all that has been narrated from the Prophet: his actions, his sayings, and whatever he tacitly approved, plus all the authentic reports describing his physical attributes and character.

***al-Tabarru'at***

Contracts of charity.

***Takaful***

Mutual responsibility, mutual guarantee.

***Tawakkul***

Literally, trust, confidence. Trusting in God's help for positive results after making all possible efforts and awareness of God's provision for humankind.

***Tijara***

Commerce, trade.

***'Uqud al-mu'awadat***

Contracts of exchange.

***'Uqud al-mu'awadat al-malliya***

Commutative contracts.

***Wahy zahir***

Manifest revelation.

***Wajib***

Imperative – performance is compulsory and omission is punishable.

***Zakat***

One of the five pillars of Islam. It is a wealth tax paid on certain forms of wealth: gold and silver, staple crops, livestock, and trading goods.

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